

***THE
LICENSING
AND
JOINT VENTURE
GUIDE***

**Prepared by Hubert J. Stitt Q.C. and
Samuel R. Baker Q.C.**

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For further information contact:

Ministry of Industry, Trade and Technology
Trade and Investment Support Branch
900 Bay Street
Hearst Block, Queen's Park
Toronto, Ontario
Canada M7A 2E1

Telephone: (416) 965-9700

Fax: (416) 324-3637

French available on request.

TECHNOLOGY TRANSFER

New technologies are changing the world economy. Countries that apply technology most effectively will be the most prosperous in the future.

This book is designed to take you through the three major stages of technology transfer.

It deals first with why you should consider seeking technology outside your own resources.

The second part is a practical "how to" approach to acquiring foreign technology including goals, methods of search, sources of technology, evaluation of potential licensors and process of negotiation.

John W. Morehead's extensive work *Finding and Licensing New Products and Technology** has provided material for Parts I and II which have been prepared with his approval and cooperation.

Part III deals with actual implementation of technology transfers by outright purchase, licensing and joint ventures.

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PART I

DETERMINING YOUR NEED



ACQUISITION OF RIGHTS AS A MEANS OF CORPORATE GROWTH

In order to prosper, a business must grow. Corporate growth can be thought of as increases in sales and profits as a result of expansion and/or diversification. Traditionally, a manufacturing business has grown in one of two ways. The first is by manufacturing new products developed as a result of research conducted by the business itself. The second is by the purchase of the business of another, sometimes a competitor, a supplier, a customer or occasionally a person in an unrelated business.

Unfortunately, both of the above alternatives may be beyond the resources of small businesses, in that they could exhaust their available capital and labor resources.

The purpose of this book is to alert the owners or managers of small businesses, in particular, to a third way which is more appropriate where resources are limited. That third way is the acquisition of rights relating to products of other companies. We explain the types of rights that might be acquired and deal with the commercial and legal problems relating to this alternative. Benefits and means of acquisition are also considered.

Initially, let us examine the two traditional methods of growth and assess their advantages and disadvantages.

INTERNAL GROWTH — RESEARCH & DEVELOPMENT

Originally, one common method of business expansion was the development of new products or variations of existing products by employees of the business. An obvious example is the growth of the automobile industry. Each company developed a wide range of vehicles designed to appeal to different segments of the market. These variations were initially the result of carefully safeguarded internal planning and development.

Although exclusivity and secrecy may be two benefits of this approach, it has a number of disadvantages.

Conducting research and development is very expensive, requiring the expenditure of significant

amounts of money on equipment and facilities. Skilled personnel, such as engineers and scientists, must be hired to carry out the research activities. Not only is it difficult to locate such people, they command high salaries and good working conditions.

Furthermore, the results of their efforts cannot be guaranteed. You cannot require that an invention be made, since it is the result of imagination and creativity. Also, presumably, others are pursuing the same search for new products, and it is possible that they will develop the new product successfully themselves before you do. Meanwhile, you have expended a great deal of effort and money and have nothing to show for it.

Needless to say, this search for new products may be very lengthy, and, even if a competitor does not develop the new product first, by the time you manage to perfect it, the marketplace may no longer be interested in it.

Thus, the conduct of your own research and development is likely to be very expensive and time-consuming and the results completely unpredictable. A small business cannot "play the percentages" as readily as a large organization that will undertake a number of research projects at one time.

EXTERNAL GROWTH — ACQUISITION OF BUSINESSES

Some of the disadvantages associated with internal growth can be overcome by acquiring a business which is already in existence.

You can determine the area in which you wish growth to occur and then seek out a business which qualifies. For example, you may determine that the most profitable area of expansion might be a product that complements your own — if you manufacture tooth brushes, you may start producing toothpaste. Alternatively, you may obtain direct sourcing of the raw materials required and purchase a plastics business. Another option might be to become more involved in the marketing of tooth brushes and purchase a drug store. A fifth

possibility is the purchase of a business that manufactures an improved version of the tooth brush. While these are simplistic examples, they do illustrate the range of possibilities that exists for a business wishing to expand.

Thus, having made the decision with respect to what form expansion should take, there is then the requirement to identify the actual business to be acquired and to locate the funds required to effect the purchase.

In acquiring the business, not only do you achieve a form of expansion, you also acquire a whole new group of assets and liabilities and the problems associated with them. The business as a whole must be evaluated, and the feasibility of acquiring it assessed.

Once again the search for the "right" business and the negotiation of its purchase on acceptable terms are likely to be time-consuming and tedious. Furthermore, its acquisition is likely to be an expensive undertaking and financing is often not easily available on attractive terms.

ACQUISITION OF TECHNOLOGY

Technology, broadly defined, refers to knowledge relating to goods and services, and including not only the goods and services themselves, but also the methods of producing, delivering and marketing. Thus, the third method of growth is the acquisition of such knowledge called the New Product Search.

The advantages are discussed in more detail subsequently, but are fairly succinctly summarized in the following chart showing the comparative advantages of the three primary corporate growth strategies:

	Internal Research & Development	Corporate Mergers & Acquisitions	New Product Search
Selection of New Product Opportunities	limited	large	very large
Probability of Getting What You Want	low	high	very high
Time Required to Enter New Market	long	existing	short
Predictability of Cost of Action	low	very high	high
When Cost of New Product Acquisition is Paid	long before product is marketed	just before product is marketed	mostly after product is marketed
Cost of Withdrawal or Failure	high	very high	low

There are a number of means in which technology may be acquired, but the most common method is through licensing. The license agreement would normally give the user of the products or technology (the "licensee") the right to manufacture and sell in an agreed upon market area. For this privilege, the licensee would compensate the owner of the rights ("licensor") by means of a royalty, generally in the range of 2 — 10% of the licensee's sales of the licensed goods. The royalty is sometimes preceded by a down payment to cover the licensor's costs of transferring the rights and know-how and to represent good faith and determination on the part of the licensee. In some cases, this down payment is credited against future earned royalties.

It is estimated that in the past ten years an average product life cycle of 10 to 12 years has shrunk to perhaps 3 to 4 years. As a result, the importance of licensing and technology transfer on a worldwide basis has increased. Companies find it impractical to rely on their own internal resources to develop short-lived new products. Sharing the burden of technology creation must take place and licensing is a natural business practice that can meet this need.

We now live in an era where most products are susceptible to fast and sudden technological obsolescence. We have only limited resources in terms of time, talent and finances. Therefore, smaller companies, in order to survive, have to become either very technologically innovative or dependent on those who are successful in this area. Thus, licensing becomes a vitally important tool for growth and survival for all but the largest of companies.

ADVANTAGES OF TECHNOLOGY ACQUISITION

AS A MEANS OF GROWTH

External growth through licensing has several unique advantages over both research and development and mergers and acquisitions.

Overall Productivity Improvement

By obtaining a license, a company is able to take advantage immediately of the experience and know-how of the licensor. This immediately increases productivity, not only because of the new licensed product, but also because more time may then be spent on improving older products and their manufacturing methods.

More Rapid New Product Development

With the increasing costs of research and development, many companies will find it necessary to look outside for new products and technology. This will result in more meaningful international relationships and should provide the basis for accelerating the pace of technological change. When a company does not have to spend its efforts on developing basic technologies, its growth is accelerated. Basic research is of utmost importance, but if through technology transfer companies can keep from "reinventing the wheel," the improved products and processes will contribute to a better life for all at a faster rate.

Improvements in Production Processes

With rapid increases in technology, it has become more important than ever for a company to know not only "what" to produce but "how" to produce it in an efficient and cost-effective manner.

If a company is devoting most or all of its research and engineering capabilities to answering the question of "what" to produce, it falls prey to other companies who are able to spend more time on "how" to produce a product more efficiently and profitably. In other words, while a company is using all of its internal capabilities to generate new products, its competitors throughout the world may be developing methods of producing their existing products in a more efficient fashion. Thus, the competitors will be able to undercut prices and possibly take away a market from an established

manufacturer.

If a company has an organized program for finding new products and technology that can be produced under license from outside sources, then it can devote more of its research and engineering working hours to developing more efficient methods of producing its existing products.

MAXIMIZING CONTROL; MINIMIZING COST AND RISK

The following is a list of reasons why companies decide to acquire technology:

- (1) Product life is becoming increasingly shorter. Licensing can ensure a steady flow of new products.
- (2) The cost of acquiring fully-developed new products through license is estimated to be as little as 2 — 10% of the cost of developing comparable products internally.
- (3) The lead time for introducing new products is reduced dramatically through licensing.
- (4) A company can easily and accurately predict its developmental and front-end costs for new products acquired through license.
- (5) If a licensed product does not become successful in the marketplace, downside risk is minimal.
- (6) Products manufactured under license increase cash flow because development costs are paid **for after the products are sold** (via royalties) rather than before entering the market.

ANCILLARY BENEFITS

Obtaining technology and the search for it have interesting beneficial side effects. By visiting with counterpart manufacturers throughout the world, it is quite possible you will find new ideas and techniques that relate to types of production machinery used, plant layout, work methods, suppliers and new products.

In the area of production, the following benefits are possible:

- (1) Increased output as a result of the licensed

- new product.
- (2) Reduced unit labor costs for existing products by directing engineering efforts to this area rather than entirely on developing new products on one's own.
 - (3) Increased productivity through greater utilization of working hours which were not fully utilized prior to the integration of the licensed new product.
 - (4) Reduced working hours as a result of bringing in new technology relating to automation and work methods through a specific search in this area.

Even if a technology transfer arrangement is not concluded, the opportunity to perform profitable subcontract manufacturing may occur.

Some interesting marketing opportunities may present themselves in terms of export markets and the products of a prospective licensor. It may well be that the source company has no products which you would be interested in producing under license, but it may have products you could distribute in your home and export markets.

The possibility of cross-licensing may arise because the companies that are sources for offering you new products under license are also the ones who might logically be interested in your products and technology. Therefore, as a by-product of a New Product Search, you may obtain a new licensee for some of your technology.

Another possibility is the joint development of a market in a third country. A New Product Search can produce other opportunities for more fully utilizing your facilities and contributing to increased profits. These other possible benefits **must** be thought of as a bonus for your efforts and should not be planned for initially.

IDENTIFYING THE ASPECTS OF A BUSINESS MOST LIKELY TO BENEFIT FROM TECHNOLOGY ACQUISITION

With respect to seeking manufacturing technology, the following companies are potential beneficiaries:

- (a) The company which possesses excess manufacturing capability in the form of idle or underutilized machinery or equipment.
- (b) The company which wants to introduce new products, but does not have the budget for purchasing new equipment or facilities.
- (c) The company which performs a special manufacturing function, where there are few competitors and high capital equipment requirements keep others from entering the field.

With respect to engineering, if you possess particular, in-depth engineering expertise or capabilities, you can direct your search along these lines.

From a marketing point of view, companies are looking for extensions of existing product lines as well as new product lines that can be sold to their existing markets.

Your search can be based on manufacturing, engineering or marketing capabilities you possess and can include any combinations of those capabilities.

If you are developing what seems to be an important new product, it is in your best interest to also conduct a New Product Search in that area at the same time. It is quite possible you may find that another company somewhere in the world is doing the same thing you are in terms of new product development, and you both might even be using the same approach. In that case, you might want to reevaluate your development program in terms of the potential competitor your search uncovered. On the other hand, that other company might be more advanced in its development than you are and possibly a license agreement could help you bring the product to market faster than if you proceeded independently.

DETERMINING SUITABILITY OF CURRENT OPERATIONS FOR NEW TECHNOLOGY

A CHECKLIST

A checklist permits you to evaluate whether your business can benefit from an acquisition of technology:

Would you like to utilize your manufacturing facilities more fully?

Licensed new products or technology may be produced in your own facilities using your existing machinery, thereby offering better utilization of your facilities.

Could your production staff work more to their capacity if only they had more work to do?

If workers are currently working at less than capacity, their excess time can be devoted to the production of new licensed products.

Do you wish to avoid the pitfalls of your products being in a mature or declining market?

You can effectively broaden or diversify your market position by taking license on a new product in a field chosen by you that represents good growth potential.

Would being able to introduce a new product within the next 12-16 months be beneficial to your company's overall image and momentum?

You can normally expect to have a new, licensed product in production within 12 to 16 months after initiating your search. This includes time for researching potential licensors, making contact with them, reviewing the products they may offer for license, negotiating the license agreement and implementing the production of the new product. In many cases, this time frame can be shortened significantly.

Are you in a position where a merger or acquisition is not feasible or desirable?

If your company does not wish to merge with another or if you are in a position where there are no viable acquisition candidates available in your area of interest or within your financial capabilities, then licensing new products offers an excellent form of corporate growth.

Are your current R&D efforts minimal or directed to projects which may not reach the market stage for a number of years?

If your possibilities for growth are limited, going outside your organization and licensing a product

from another company can fill this innovative gap at a minimal cost. If all your company's research efforts are committed to major projects that may not reach the market stage for several years and you need the new products now, licensing offers a chance to quickly assimilate new products and technology.

Would you like to be able to broaden your product line with minimal effort?

If your current products are successful and you enjoy good marketing strength, you can capitalize on that capability by manufacturing and marketing under license products which are compatible with or complementary to your own and which can be easily integrated into your existing marketing efforts.

Would you like to be able to introduce a new product which has already been proven successful and possesses international prestige?

In many cases, a product produced under license has already met with success and enjoys a favorable track record in its home country. The fact that a licensed product was developed in another country can lend prestige to your home market sales efforts.

Would you like to reduce product development costs by as much as 90%?

By producing products under license, you allow other companies to do your product development work for you. It has been found that you can acquire the rights to a fully developed new product under license for as little as 10% of its actual development costs.

Would you be interested in deferring most product development costs until after the products are sold instead of having them be at risk?

When your new products come from internal research and development efforts, all of the development costs are paid for before they ever come to market. These costs are substantially at risk since you cannot be certain that the results of internal R&D will be successful, let alone marketable. When products are produced under license, their costs to you are paid for usually in the form of royalties which are based on products sold. Therefore, your cash flow position is considerably improved.

WHEN TO COMMENCE THE SEARCH FOR TECHNOLOGY

The best time to start a New Product Search program is **now**. If your business is not doing well, it may help provide a cure. If your business is booming, you will never be in a better position to afford the effort and cost of the acquisition of new products. The underlying theme is that an ongoing New Product Search effort, through good times and bad, will provide you with a continuous supply of product offers which you may evaluate and accept.

Experience has shown that most searches are initiated as a result of decreasing sales and/or profits. A company realizes it must have an infusion of new products in order to maintain, and possibly improve, its financial performance.

When a company's business starts to deteriorate, it generally is not in a favorable position to finance an adequate search effort. Also, searches conducted under "crisis conditions" tend to be hastily done and superficial. A company seeks out the "quick fix" that will eliminate a short-term problem, while offering little in the way of real long-term growth.

PRE-SEARCH

Having reached the decision that acquisition of technology would be advantageous for your business, you must then plot your strategy for the kind of technology most appropriate for your business. It is necessary to conduct a thorough examination of your company in all respects.

GOALS

The following checklist may assist you in this preliminary fact-finding process:

What problem or problems are you really trying to solve through your search?

Remember, there may be a number of them. Do you want to increase profitability, make better utilization of excess plant and personnel capabilities, increase your engineering sophistication, diversify your product line, extend your product line in your current market, etc.? If

you cannot think of a problem that the search would solve, it may not be worthwhile.

What have other companies done that can solve your problem and fulfill your search interest?

It would be ideal if you can come up with examples of two or three products produced by other companies that would be similar to ideal licensing offers for you. If this is not possible, you may wish to draw a parallel between your situation and your search interests and how another company, perhaps in an entirely different industry, solved its problems. For example, a company producing machinery related to the packaging industry may wish to reduce its dependency on machinery orders alone for revenues. By looking at the safety razor industry, you can see that a successful company like Gillette produced a machine (the razor) and was able to generate a constant and continuing income from the material that was used in the machine (the razor blades). Therefore, drawing such a parallel to an unrelated industry, it might be suggested that for a company in the packaging machinery area you might consider Signode, a manufacturer of machines (strapping equipment) as well as the consumable material which provides a continual source of income (metal and plastic strapping bands). If you cannot find some sort of reasonable parallel to your search problem, it will be very difficult to be successful in your program.

Through what type of basic mechanism can your search interests be fulfilled?

If you are interested in a new type of control device and you are primarily a producer of mechanical controls, could the product you are searching for be produced utilizing electronic as well as mechanical technologies? If you are looking for a new chemical process, is it one which might be accomplished through biological engineering as well as through conventional processing? In essence, if you are searching for a technology and cannot identify whether it will be a mechanical, electronic, chemical or biological technology, you may have extreme difficulty in reaching a successful outcome.

Can your search interests reasonably be fulfilled using your present personnel and facilities, within a reasonable period of time and within the financial capabilities of your company?

For example, if you were a small fabricator of stainless steel tanks, you would not want to pick genetic engineering technology as a search interest. It is not likely that such technology would be within the expertise of your personnel, nor would it relate to your production facility and equipment. This is an area which may take a number of years to reach true commercial importance and due to your small size and modest financial situation you would not be in a good position to fund such a program. Therefore, see that your search interests are within your means and capabilities.

Do your technological capabilities relate to the search area?

It could be that your search area will require considerably more technological expertise than you have or can develop. For example, if you manufacture mechanical watches, you might feel that you are comfortable in the area of timekeeping devices. However, in the case of digital watches it is unlikely that there will be any in-house expertise of any depth to handle such products, although they are certainly timekeeping devices.

What will the product or technology be worth to your company?

You should not embark on a search unless you feel that the result will contribute in a meaningful way to profits, or perhaps your technological and engineering expertise. In essence, you should not become so overwhelmed by a technical novelty that you forget that it may have a very limited market. However, if a certain technology has a limited sales volume but would contribute to the overall increase in the sophistication of your company, it might be considered a worthwhile search area.

Have your search interests been discussed fully with key individuals in your company, and perhaps others?

Before you make a commitment to a search area, you should review the subject with appropriate marketing, R&D, top management and other colleagues who might be able to make helpful suggestions or modifications. This will prevent you from completing a search in an area where top management has no interest. If you can do it in a discreet manner, you might want to review your search interests with key customers who would be affected by the new products that would be licensed

by your company. They might tell you they really do not need the product which you feel they do. But, they might be able to suggest viable search alternatives.

Development of a company profile is an important tool in your search for technology. It not only helps you identify the technology but it also assists you in attracting the interest of potential technology suppliers.

A company profile also:

1. Helps organize your thoughts about your company.
2. Gives you a guide to use in the verbal, in-person presentation of your company to another party.
3. Supports what you have said about your company.
4. Leaves the prospective licensor with something from which to remember the important facts about your company.
5. Fills in the gaps that are left by other promotional information regarding your company.
6. Subtly states certain things about your company which you may not wish to bring up in a meeting on your own initiative since they may give the impression of being too detailed or possibly boastful.

A company profile, properly prepared, can be an indispensable marketing tool. Once the relevant information is gathered, it can be presented in such a fashion that it is attractive and informative to potential licensees.

A sample of a company profile is included herewith as Appendix I-A.

UNDERSTANDING A LICENSOR'S PERSPECTIVE

In locating and negotiating with a licensor, it is important to be able to understand its perspective on the supply of technology to you rather than, for example, the licensor itself exploiting its technology in your territory.

Advantages

Obviously, there are advantages for the licensor in proceeding by way of a sale or licensing of technology. These include the following:

- (a) It is a means of expansion in foreign markets

- without significant capital investment.
- (b) It is a source of revenue.
- (c) It may also permit expansion where it would otherwise be legally prohibited — by reason of restrictions on foreign investment or income repatriation.
- (d) It may result in preferences being available — such as governmental policies encouraging the purchase of locally produced goods.
- (e) It provides to the foreign licensor knowledge of and an introduction to the local marketplace.
- (f) It permits reduced transportation costs.
- (g) There is little risk associated with this form of entry into foreign markets especially in view of the little capital invested.
- (h) There is the possibility of obtaining additional technology from the licensee.
- (i) There are often tax advantages relating to the payment of royalties rather than the payment of dividends.
- (j) The result of a license may be the creation of additional markets for sale of ancillary products of the licensor — for example, the technology licensed relates to the manufacture of cameras, but not film — thus, new markets may be created for the sale of film.

Disadvantages

Licensing of technology also has its disadvantages from the licensor's viewpoint. These must be understood, so they can be minimized in the course of negotiations. They include the following:

- (a) It may be difficult administratively for the licensor to be involved in foreign markets both through its own operations and through licensing — it may prefer to maintain a uniform approach.
- (b) The licensor may prefer to maintain full management control — including quality control, control over merchandising and policies.
- (c) The Licensor may feel that it is of prime importance to maintain standardization throughout its operations — to ensure the interchangeability of parts and high quality.
- (d) Licensing may involve limited profit potential.
- (e) The licensor may believe that appointment of a licensee is, in effect, simply establishing a future competitor.

Accordingly, keeping in mind the above factors will assist you in conducting more effective negotiations.

KNOWING YOUR COMPETITION

In addition to knowing yourself and the party with whom you are negotiating, it is essential that you know your competition. For example, many licenses will be offered only to the large, well-established companies.

If you represent a small company, you know you will have to take an even more aggressive position in searching out license offers.

The following are issues which motivate a licensor to deal with a larger company as its licensee:

Identification — The licensee company may already be known to the licensor.

Financial Resources — Every licensor would be happy to find a licensee capable of making a significant down payment for the transfer of proprietary rights and know-how.

Facilities — The larger a company is, the greater the chances are that it will possess the proper manufacturing facilities and equipment to produce the products to be licensed.

These are factors that a smaller company must be prepared to deal with if it is to be successful in obtaining a license. One approach would be to indicate that its smaller size permits it to offer more individualized attention to the development of a market for products resulting from the licensor's technology.

APPENDIX I-A (SAMPLE COMPANY PROFILE)

XYZ MANUFACTURING CORP.
123 Main Street
Toronto, Ontario M5H 3K6
Telephone 416-555-1212
Telex 00 0000

All figures are approximate

Basic Company Facts

Founded 1948
1982 Annual Sales \$25 Million
150 Employees
25,000 Sq. Ft. Manufacturing

Production

Approximately 35% of production is job-order (custom).
Approximately 65% of production is repetitive.
Approximately 20% of production is subcontracted.
Company is currently operating at 80% of production capacity.
Company is capable of adding 50% to total capacity through expansion within one year.
Production is moderately seasonal, with a peak in the Fall.
110 employees are directly involved in production.

Markets

Total industry sales last year were \$150 million.
Total industry sales 5 years ago were \$65 million.
Market share is approximately 16%, as opposed to 8% five years ago.
Average sale is \$12,000 and 70% of customers become repeat customers.
10% of sales are exported, primarily to Latin America.
Primary purchasers of our products are (1) chemical companies, (2) pharmaceutical companies, and (3) the food processing industry.
Primary influences on the purchase of our equipment are (1) plant managers, (2) facilities engineering departments, and (3) consulting engineers.

Research and Engineering

20 employees are involved in research and engineering.
Since founding, the company has been issued 27 Canadian patents and 110 foreign patents in various countries.
Our primary product line has been redesigned on average every 5 years.
Our products have won 3 Process Industries Equipment Awards for uniqueness of design and engineering.
We were the first company in our industry to offer units with electric heating capability (two years prior to the shortage of natural gas).

Sales and Distribution

Sales are national in scope, but 65% of sales are in Ontario.
10 employees are involved in sales and related support activities and we utilize a network of 12 local representative firms.
We have developed a formal sales training program for our employees and reps and have regularly-scheduled meetings twice per year (usually in conjunction with the announcement and introduction of new equipment models and revisions).
Our Latin American export sales are handled by an export management firm.
Since 1957, we have had a licensee for our products in the U.K. (Smith Brothers Ltd.) and they presently enjoy a 30% share of the U.K. market.

Information

We are appending to this profile the following information on our company and its products:

- Catalogues and Brochures
- Sales Training Handbook
- Financial Statement
- Copies of Advertisements
- Price and Parts Lists
- Public Relations Materials
- Organization Chart
- Photo of Trade Show Exhibit

PART II

SEARCHING FOR TECHNOLOGY



HOW TO SEARCH

SOURCES

Where do interested Canadian firms find out about licensing or joint venture opportunities?

Many avenues should be pursued in a search for foreign technology. They are:

Computerized Data Bases

One example of a computerized data base is the ORBIT System of System Development Corporation. This system covers over 80 data bases with more than 55 million citations from such sources as journal articles, patents, books, theses, conference papers, annual reports, grants, newspaper articles, summaries of research in progress and statistical and tabular data. It provides literature and information regarding the products being sold or directory and trade list type information which lists companies to contact.

Contact: Pergamon ORBIT Infoline
8000 West Park Drive
McLean, Virginia 22102
(Phone 703/442-0900)

Data banks containing announced or published licensing opportunities are described in Appendix II-A hereto.

Trade Directories

One of the best references is called Trade Directories of the World which is a looseleaf volume that is supplemented on a regular basis. It lists approximately 3,500 directors from 175 nations, indexed by 687 categories.

Contact: Croner Publications, Inc.
211-05 Jamaica Avenue
Queens Village, New York 11428
(Phone 718/464-0866)

If you are searching for "cutting edge" technology, it would be worthwhile to make an extensive survey of research laboratories. If your interests are already in commercialized products and technology, the laboratories are not such pertinent contacts. The directories listed in Appendix II-B may reveal a number of laboratories working in areas of interest to you.

Trade Associations and Professional Societies

Trade associations and professional societies are an essential research source.

Trade associations can vary greatly in size and scope. For example, the American National Electrical Manufacturers Association (NEMA), is the largest trade organization for manufacturers of electrical products in the United States with from 500-550 member companies.

Professional societies may be defined as organizations of individuals with a common background in a subject, whose chief purpose is to apply their knowledge for professional or monetary gain.

An authoritative and comprehensive source of information relating to locating and identifying trade associations is the directory, National Trade & Professional Associations of the U.S. and Canada and Labour Unions. The directory contains a subject index which is helpful in locating the associations in particular areas of interest. Information such as the names and addresses of the organizations, the numbers of members, budgets and the size of the staff are contained in the directory. The directory also lists the periodical publications of each association along with the date and place of its annual meeting.

Contact: Columbia Books Inc.
1350 New York Ave. N.W.
Suite 207
Washington, D.C. 20005
(Phone 202/737-3777)

Trade Journals

Trade journals can be an invaluable source of information in your search for outside technology. The type of information which may be gathered from such journals includes:

Reference to new products and technology through advertisements and new product announcements carried in each issue.

Reference to manufacturers of products which could be of interest to you through their annual directory buyer's guide issue.

Special reports on your area of interest in special issues throughout the year.

There is a directory of trade journals entitled

Business Publications Rates and Data which may assist you in finding relevant publications.

Contact: Standard Rate and Data Service Inc.
3004 Glenview Road
Wilmette, Illinois 60091
(Phone 312/256-6067)

As you review various journals in search of licensing opportunities, a few ideas to be kept in mind are:

- Look at the ads carefully.
- Review the table of contents fully.
- Carefully analyze and act on industry news.
- Watch for feature articles in your areas of interest.
- Review new products and new literature columns closely.
- Follow industry personnel changes.
- Note the book reviews.
- Watch the classified advertisements.

Reviewing Patent Literature

Patent literature is a valuable source for those in search of unique licensing opportunities.

A continuous review of U.S. and Canadian patent literature may be helpful for the following reasons:

- The U.S. Patent literature represents the largest and most comprehensive collection of technical information in the world.
- Technical information in patent literature can be quite detailed and revealing since a patent will not be allowed if there is insufficient disclosure of key information.
- By definition, the patents contain descriptions of new and unique devices and ideas.
- Patents can reveal the identity of corporations working in areas that would not normally be associated with those companies.
- Patents can be used to identify new, embryonic corporations doing creative work.
- Patent literature usually contains a discussion of the state of the art of the invention and how it relates to or differs from prior inventions.
- Discussion and information contained in patents can be valuable in that it may have never appeared in any other published literature sources.
- Since claims are the essential coverage of the patent, it is possible to use these as a basis for one's own invention by seeing that a different approach is taken which will not infringe on existing claims.
- A skilled patent searcher can identify patents in an unrelated field or industry which might have application to his own.

- Patents generally reference prior patents which are related to the subject invention. Such references can be helpful in locating additional sources of information in a field of interest, or finding a similar, but different, approach to a problem.

The U.S. Patent and Trademark Office publishes a weekly gazette, the "Official Gazette", containing abstracts of issued patents. These abstracts are organized into three major groupings:

- (a) General and Mechanical
- (b) Chemical
- (c) Electrical

In addition, an alphabetical list is presented of all the patentees whose patents are listed in the particular issue.

Such a list helps you monitor patents that have been issued to your competitors or other corporations of interest.

Subscriptions to the Official Gazette can be ordered through:

U.S. Government Printing Office
Washington, D.C. 20402

In Canada, abstracts of issued patents are listed in the "Patent Office Record".

Contact: Supply and Services Canada
Publishing Centre
45 Sacred Heart Boulevard,
Hull, Quebec
(613) 997-2560
\$1.25 per copy

Scouting Large Corporations

Most major corporations have patent portfolios containing hundreds, if not thousands of patents.

Some of these companies include Pillsbury, Eaton, Armstrong, Rohm & Haas and American Can. They are generally large corporations who are listing what might, in some cases, be called "spin-off" technology or "research and development byproducts". These may be patented developments or products which the developing company decided not to market for a variety of reasons. They may also be patented pieces of equipment or proprietary mechanisms of a system which the company developed in reference to its own manufacturing needs.

By compiling and having available for distribution such listings of patents available for license, these companies are trying to recoup some of the expenses incurred in the development of these patented articles. Although many of them will be almost pure patents, or very little commercial information available, a number of them may represent products which were almost

fully developed but never brought to market. Such fully-developed products could ideally fit the more modest expectations of a smaller company. These are the true bargains in licensing opportunities. This is the area where you may acquire a fully-developed new product line for as little as 5% of its original development cost.

It would be worth your time and effort to review copies of the Fortune 500 and second 500 lists, as well as the Forbes 500 lists, to identify those companies that might possibly have developed technology in your areas of interest.

Many large corporations have recognized that they are sitting on untapped resources in the form of underutilized patents. They have begun to establish departments or groups that catalogue and market these technologies.

Research laboratories are key sources of new products and technology. You will initially want to make a distinction between corporate research laboratories and independent (not affiliated with a manufacturer) research laboratories.

You will be contacting the corporate research laboratories in an indirect manner since your search inquiries to manufacturers will generally be directed to chief executive officers.

Scouting Smaller Companies

Attractiveness of "Embryonic" Companies

You will want to scout the large and medium sized companies, as well as the bureaucracies (the government agencies and universities). However, it would be foolish to embark on a New Product Search and not know where your emphasis should be. You could spend an entire year visiting all the "big guys" in your industry without producing one valid licensing opportunity. Instead, you have to "beat the bushes" to uncover the tiny companies with truly innovative products that may be the answer to your search.

The reason these companies are generally more efficient and innovative than the large companies is that most of them do not have much diversity in their product lines. They occupy a relatively small or vulnerable market position and have less specialized staff. By virtue of being tiny, they face crucial decisions almost all the time. This trains them to become alert to opportunities.

If you are searching for breakthrough innovations, you should concentrate on "embryonic" or start-up companies. For example;

In its 1977 report, "Small Firms and Federal R&D", the U.S. Office of Federal Procurement Policy, Office of Management and Budget, concluded that:

"Small firms have compiled a striking record of innovation in the private sector. Firms with less than 1,000 employees accounted for almost one-half of major U.S. innovations during the period 1953-1973.

In spite of the above record in innovation...small business received only 3.5 percent of total Federal R&D."

In 1977, the National Science Board, in its study "Science Indicators 1976" for the National Science Foundation, stated that:

"On the basis of a sample of major innovations introduced to the market between 1953-1973, small firms (with up to 1,000 employees) were found to produce about 24 times as many major innovations per R&D dollar as large firms (over 10,000 employees) and 4 times as many as medium-sized firms."

Reasons for Attractiveness

Here are several reasons why new ventures and developing companies may be the most interesting sources of new product licensing offers:

- (i) The founders of the company feel their product has enough merit to start a new venture, often with their own capital and commitment.
- (ii) Because the company is new, capital is probably short and they are not in a position to consider establishing their own manufacturing facilities in foreign countries. Therefore, they are ripe for a license arrangement.
- (iii) The potential down-payment in a license agreement will be an important contribution to initial cash flow for the new company.
- (iv) Being a new business, the executives have a more open attitude in terms of working with others and are quite possibly more accessible and attentive to comments and suggestions from the licensee.
- (v) There is a certain important element of excitement that comes into play in new ventures. Hopefully, this excitement will rub off on your own company through a license arrangement. In turn, you can benefit from a boost in morale and enthusiasm of your employees.
- (vi) If the embryonic company is offering a new and novel product, you are afforded the opportunity of being in on the ground floor of a growth market that could lead to even greater overall potential for your company.

- (vii) By becoming the licensee of an embryonic company, you are offered a chance (albeit a risky one) to align your company with a company or trade name that may well revolutionize an industry.

Locating Such Companies

It is essential that in your research and survey efforts particular attention is given to finding these embryonic companies. In most cases, they will not be readily known within an industry and you will not see much reference to them in directories or trade journal articles and advertisements. They are basically hidden from view and must be eagerly and thoroughly scouted.

Patent literature sometimes gives you a clue to an embryonic company.

Trade association executives may have contacts, although to a lesser extent, since small companies usually defer trade association participation until they can afford it.

Examples

One of the most successful high-tech companies in Ontario makes a product that few people have ever heard about.

The company is Com Dev Ltd., located in Cambridge, Ontario. Its product is a multiplexer — a clever piece of microwave hardware used in satellites. It's an indispensable gadget, implanted in the satellite, that makes a certain kind of TV signal possible — usually cable TV. It also has applications in the telephone industry.

The design, manufacture, testing and selling of multiplexers has led to a rapid corporate growth for Com Dev and generated handsome profits as well.

In 1973 Com Dev's staff comprised five persons; by 1983 that figure had risen to 220 persons. In 1981 sales revenue was \$5 million; by the end of 1983 it's expected to reach \$17 million.

Fifty percent of the company's staff are engineers or technologists. And most of the balance are skilled toolmakers and machinists.

It's not a Trivial Pursuit anymore. The board game that started with a brainwave in 1979 has now become a household word.

In 1980, originators Chris Haney and Scott Abbott along with a St. Catharines lawyer and John Haney formed Horn Abbott. Additional shares were sold to raise venture capital.

For five months, Chris Haney tracked down Canadian suppliers who were able to meet his exacting design specifications.

In a test run, 1,100 sets and boards were produced and placed on consignment with

individual game stores in Toronto, St. Catharines and Vancouver. In two weeks all of them were snapped up. But each game sold at a \$34.00 loss and the company was out of pocket \$80,000.00.

With potential proven but no money left to continue, the partners literally went to every bank in Canada. Then a St. Catharines bank manager who had played the game decided the product was worth the risk.

The faith of investors, suppliers and a friendly bank manager has been vindicated.

Expansion outside Canada has been facilitated by a manufacturing and distribution deal with a U.S. firm.

The rest is history.

Two firms have taken advantage of product licensing and joint venture opportunities in the Windsor, Ontario area. They are Intercane Systems Inc. and Valiant-Saimp Inc. The former acquired licenses and the latter entered into the joint venture with an Italian firm.

Intercane Systems decided that new products were required to reduce the dependence of the company on the automotive industry for which it had supplied complex custom machinery for some years. A search of available opportunities led the company to obtaining licenses and technical consulting expertise from five separate West German companies.

This allowed Intercane to build complete, highly automated turnkey plants to manufacture building panels from wood or other materials such as sugar cane stalks. The first such plant was built in the Philippines. Intercane subsequently developed technical improvements which were licensed back to the foreign firms on a revenue-producing basis.

A representative of Intercane says, "We couldn't possibly have made the move to manufacture our own new product line without the technology we acquired under license. It would have taken too long and too much money."

A spokesman for Valiant-Saimp, long-time supplier of custom toolings to the automotive industry, is enthusiastic about the technical "show-how" and marketing support he is receiving from his new Italian partner.

"We flew some of our people over to Italy to train in their plant," he said, "and they moved an executive and his family over to Windsor to work right with us." The result is a line of sophisticated grinding machines being manufactured in Windsor.

Venture Capital Firms

If you are searching for new, innovative breakthrough technologies, you should consider venture capital firms as a source of valuable leads to such companies.

Basically, a venture capital firm is a private investment company placing the majority of its funds in the form of start-up or developmental capital for new business enterprises. Although some venture capital firms invest in some rather straightforward and typical new businesses, most of their investments tend to be in technically innovative new companies.

The key reason for contacting venture capitalists in order to obtain leads to new products and technology is that they investigate a large number of new business opportunities. For example, it is customary for a venture capital firm to invest in only 2-3% of all the offers presented to it. Therefore, a firm investing in only one or two deals per year is probably viewing almost one hundred new business situations.

In many cases, a venture capital firm is approached by a group of inventors/entrepreneurs who have developed a new and unique product and who are looking for capital to fund the commencement of a new company to manufacture and market that product. Most of these offers come from people who have a background with a larger, established company and who may identify a market that is small but lucrative and not currently served by their employer. In some cases, the venture capital firm may, after examining the business plan, determine that the true market potential does not warrant the establishment of a new manufacturing company with its high capital investment for men and machinery. This is where you can play a role. If you have contacted venture capital firms and explained that you would appreciate their referral to new companies that they feel could benefit from an association with an established company such as your own, then you may hear about such opportunities.

It has been estimated that there are from 125 to 150 venture capital firms working today in Canada and they are playing a growing roll with active governmental encouragement.

In addition, there is a very active and large group of associated firms that assists new companies and other ventures in finding venture capital funds. Often these intermediaries may be important sources of leads.

You may contact the Association of Canadian Venture Capital Companies, 1881 Yonge Street, Suite 600, Toronto, Ontario, M4S 1Y6 to obtain a

listing of Canadian venture capital firms.

To find venture capital companies in the U.S., you can consult the *Guide to Venture Capital Sources* published by Capital Publishing Corporation. It also publishes perhaps the most informative and respected newsletter of the industry, "Venture Capital Journal". It lists over 500 venture capital sources and has detailed descriptions of their activities, that is, investments in certain technological areas, such as electronics and data processing, etc. The current price for the guide is \$130.

Contact: Venture Economics Inc.
P.O. Box 81348
Wellesley Hills, Massachusetts
02181
(Phone 617/431-8100)

A sample of a letter for use in contacting venture capital firms is included as Appendix II-C.

Letters to Patent Attorneys

A mailing to patent attorneys is recommended. They are in constant contact with a diverse range of inventive and innovative persons and organizations by virtue of their profession. They are also in a good position to relay your search interests to a client who may not have immediately available the products or technology which you are seeking, but who may well have the capabilities to fulfill your search requirements.

Contact only those patent attorneys in private practice since patent attorneys employed directly in industry are not usually good licensing contact points.

Appendix II-D is a sample letter to a patent attorney outlining a hypothetical search.

University Research

In the U.S., about 100 colleges and universities are considered major research institutions, of which only 20 or 30 do 80% of all university research.

A good, inexpensive source of names and addresses for all colleges and universities in the U.S. is the 1983 edition of the *National Directory of Addresses and Telephone Numbers* which includes more than 4,100 listings comprised of two-year, four-year, graduate and professional colleges and universities. A similar Canadian guide is the *Directory of Canadian Universities* published by the Association of Universities and Colleges of Canada.

Contact: 151 Slater Street,
Ottawa, Ontario
K1P 5N1

Universities develop spin-off technology that they try to market and The Society of University Patent Administrators (SUPA) has approximately 190 members representing about 60 universities in the U.S., and these members are the persons you want to approach in terms of finding new technology available for license. Although SUPA does not have a freely disseminated membership list, if you outline your areas of interest, you can be put in contact with appropriate members.

Contact: Patent Administrator
University of California
Systemwide Administration
1320 Harbour Bay Parkway
Suite 150
Alameda, California 94501
(Phone 415/748-6600)

Perhaps the most efficient way of tapping university research is through the Research Corporation. This patent marketing organization is described in Appendix II-E.

Some universities publish listings of patents or technology available for license, as well as research disclosures available for further development.

One of the most comprehensive and wide-ranging efforts in this area is the series of "Invention News" abstracts made available by the Massachusetts Institute of Technology. They are available in the following categories:

1. Biochemistry
2. Chemical
3. Communications
4. Computers
5. Construction
6. Power Systems
7. Electrical/Electronic
8. Electromechanical
9. Open
10. Energy
11. Instrumentation
12. Mechanical Devices
13. Medical
14. Metallic Materials
15. Non-Metallic Materials
16. Food
17. Optics
18. Pollution Control
19. Semiconductors
20. Solar Energy

To receive copies of the abstracts which are pertinent to your interests, address your correspondence to:

Technology Licensing Office
Massachusetts Institute of Technology
77 Massachusetts Ave. Room 32-300
Cambridge, Massachusetts 02139
(Phone 617/253-6966)

Participation in Product and Technology Licensing Exhibitions

A number of exhibitions are held throughout the world where the subject is technology available for license. Licensing exhibitions offer the chance for companies to show the products and technology which they have available for license and for other companies to meet with prospective licensors from around the world.

The mistake you must not make is in assuming that the licensing exhibition is the answer to your search.

Would you expect that among 500 companies from all over the world representing diverse sectors of industry there would be the one company exhibiting the product or technology that would fulfill your own unique needs?

Before you jump at the opportunity to attend a licensing exhibition, stop and determine whether its probable benefit justifies its cost.

Organizations Involved in New Product Search and International Licensing

There are a small number of professional associations and societies whose purpose and interests are closely related to the fields of New Product Search and International Licensing.

The Licensing Executives Society (LES) is the dominant association in this area and similar associations are described in Appendix II-F.

Locating Inventors

In February, 1982, the American National Congress of Inventor Organizations was established by 29 non-profit inventor organizations from around the U.S. These member organizations are primarily local-level inventor associations or clubs that were established to encourage inventors to help themselves by sharing experiences and improving their access to information.

These local inventor organizations can range from small groups located in rural areas to a huge group such as the California Inventors Council, with a membership of over 2,000 people.

Some of the organizations publish newsletters that are distributed to their members. They will

print your search interests in these newsletters.

The American Association of Small Research Companies (AASRC) is a non-profit organization to further the interests and welfare of small R&D and high technology companies. In light of the important contributions made by such innovative sources, the AASRC becomes an important source for anyone conducting a New Product Search in the U.S.

One of the most pertinent activities of the AASRC to your interests is its series of Industrial Innovation Conferences. These are generally two-day programs designed to bring buyers and sellers together to offer technology for sale or license to companies who are actively seeking products and processes which may improve their existing products or lead to new business opportunities.

During these conferences, there are also a number of workshops convened in which each participant can present the specific technology which he has available or which he is seeking. These workshops are structured around general technology areas such as the following:

- Consumer Products
- Energy
- Materials (plastics, chemicals & metals)
- Environmental
- Instrumentation and Control
- Biomedical

A firm which is particularly active in promoting the inventions of its clients is Invention Marketing Incorporated. Upon request, it will send a free copy of its New Product/Invention Register, which is an annual publication listing a large number of inventions and products offered for sale or license. The subscription rate is \$50 for a four-year period. You can also request a copy of its data bank register form. By completing this form, it can match your company's interests with inventions of its clients on a continuous basis.

Contact: Licensing Director,
Invention Marketing Incorporated,
701 Smithfield Street,
Pittsburgh, Pennsylvania 15222
(Phone 412/288-1300)

METHODS

Building a Library of General Business Directories

Business directories are essential to a new product search. The names of presidents and officers of potential licensors should be readily available.

An efficient mode of keeping track of

corporations which have been contacted in your search will help avoid embarrassing situations such as inadvertently contacting the same corporation twice, or contacting two different people at the same corporation simultaneously.

Personal Contacts

There may be people within your corporation with potentially useful contacts in your search for licensing opportunities.

Generally, contacts may be divided into four categories:

- (i) Research & Experience
- (ii) Sales & Marketing
- (iii) Manufacturing
- (iv) Senior Executive

An analysis of these types of contacts may assist you in assessing their importance and usefulness to you.

Successful Correspondence

Drafting a Search Letter.

Writing to sources of new products and technology is a key step in the search for technology. A carefully drafted search letter will help a licensee to create a positive first impression.

A good search letter follows the same general format as all business correspondence. However, it should specifically incorporate these elements:

- Attention
- Interest
- Desire
- Action

An example is included in Appendix II-G.

COSTS OF ACQUISITION OF TECHNOLOGY

There are both tangible and intangible costs associated with the decision to rely upon the acquisition of technology.

Out-of-Pocket Expenses

The real out-of-pocket costs are those associated with search for the technology, evaluation and implementation. These costs may be estimated on the basis of previous experience or information gained from colleagues or advisors.

The following checklist should be considered in formulating any budget for the acquisition of technology:

1. Costs of Search for Technology and/or contingent payment to a consultant who finds the technology (if applicable).

2. Costs of technical evaluation of the licensed product or technology prior to negotiating.
3. Costs of preliminary market survey.
4. Costs for travel and salary of negotiating team.
5. Legal costs incurred in concluding the license.
6. Costs of converting drawings and prints to metric or other standards.
7. Costs of personnel training for licensed product.
8. Costs of developing new sales, promotional and other literature (particularly if translation from English into local language is necessary).
9. Costs of technical work or modifications required to make the licensed product suitable for local market conditions, raw materials, etc.
10. Costs of obtaining patent or trademark protection (if applicable).
11. Taxes incurred on royalty payments or down payment.
12. Estimated costs of additional research and development work which may be done to licensed product.
13. Costs of acquiring new machinery or modifying existing machinery and facilities to produce licensed product.
14. Direct costs of acquiring the license including:
 - (i) Estimated annual royalty payments (estimated annual sales of product times royalty rate).
 - (ii) Estimated cost of components or raw materials that must be purchased from licensor.
 - (iii) Estimated cost of demonstration units purchased from licensor (if not included in down payment).
 - (iv) Cost of down payment, disclosure fee or upfront payment.

Obviously, these costs must be a factor in determining the desirability of a particular kind of technology as compared with another.

Intangible Costs

A risk associated with the acquisition of technology is that you become dependent upon the source of the technology. This is particularly true if you rely upon the technology source for the supply of components or advertising material or the use of its trademark. You may not be able to negotiate effectively with the other party in the event of a breach of the agreement by either party or on a renewal of the agreement.

APPENDIX II-A **Other Databanks**

Dr. Dvorkovitz & Associates,
P.O. Box 1748,
Ormond Beach, Florida 32074
(Phone 904/677-7033)

Control Data Corporation
Technology and Information Services
8100 34th Ave. S.
Bloomington, Minnesota 55425
(Phone 612/853-5643)

APPENDIX II-B **Trade Directories**

Research Services Directory
Gale Research Co., Book Tower,
Detroit, Michigan 48226
(Phone 313/961-2242)

Industrial Research Laboratories of the U.S.,
R.R. Bowker Company,
245 W. 17th St.
New York, N.Y. 10011
(Phone 212/645-9700)

Research Centers Directory,
Gale Research Co., Book Tower,
Detroit, Michigan 48226
(Phone 313/961-2242)

APPENDIX II-C **Letter to venture capital firm**

Mr. J.P. Williamson
Managing Partner
Innovative Technology Investors Corp.
44 Prudential Centre,
Boston, Massachusetts 02101

Dear Mr. Williamson:

We understand that your firm, as a Venture Capital investor, has occasion to review new ventures in the field of environmental control technologies. We are established manufacturers of environmental control products with a strong interest in new and unique technologies in this area.

We would appreciate your considering our company when you may encounter situations where:

1. You have investments in manufacturers of

environmental control products who might wish to exploit their products in our market through a license or joint venture arrangement. We would be interested in seriously considering such situations.

2. You have reviewed and decided not to invest in new ventures related to environmental control technologies. We would appreciate it if you might direct such groups to contact us since we could have interest in funding or other forms of co-operation.
3. You are considering an investment in an environmental control technology company. We would be pleased to give you our analysis of such situations based on our own expertise in this area. Of course, there would be no charge for such an analysis. We would even consider investing along with you in such worthwhile new ventures.

I am enclosing for your review some information on the background, activities and current interests of our company. I would be pleased to provide you with more detailed information if you so desire and will be glad to answer any questions you may have further to our interests and possibilities for working together.

Sincerely yours,

APPENDIX II-D

Letter to a patent attorney

Mr. Albert J. Siegel,
Siegel, Shapiro & Morrison,
209 Queen Street,
Toronto, Ontario
M5C 1J8

Dear Mr. Siegel:

We understand that you are a patent attorney in private practice and wanted to contact you regarding our interest in products available for license from your clients.

It was our impression that perhaps you may have clients whose proprietary products or technology could meet our interests. As manufacturers of precision optical instruments and systems for use in industry, research and government, we are looking for new optical related products that could be produced in our own extensive manufacturing facilities under license.

We would be pleased to have your advice regarding any of your corporate or individual clients who may have unique products or

developments which would be available for license in our country. We are enclosing a summary description of our company's history, capabilities and activities for your information.

For our initial review, we need only a brief description of the subject technology and, of course, any additional nonconfidential information that you or your clients may wish to include would be appreciated as well.

We look forward to hearing from you or your clients and, in turn, would be pleased to provide you with any more specific information on our interests and background which you may require.

Sincerely yours,

Enclosure:

APPENDIX II-E

Research Corporation

Research Corporation is a non-profit foundation which evaluates patents and licenses university developed technologies. Research Corporation has entered into invention administration service agreements with over 280 universities and colleges in the U.S., Canada and abroad.

Contact: Research Corporation Technology
445 Bayles
Port Washington, N.Y. 10050
(Phone 516/944-5120)

APPENDIX II-F

The Licensing Executives Society

The Licensing Executives Society
71 E. Ave., Suite S,
Norwalk, Connecticut 06851
(Phone 203/852-7168)

APPENDIX II-G
Sample Search Letter

Mr. XXX
President
Morris Rubber Fabricators, Inc.
123 First Street
City, Province
Postal Code

Dear Mr. XXX:

We understand that Morris Rubber Fabricators is an established manufacturer of rubber gasketing and seals.

The fast growth of the robotics industry in Ontario has created a strong demand for well-engineered gaskets and seals that will endure long periods of continuous operation. We are already serving this growing market and through a license arrangement could help you exploit this lucrative area.

We have identified a need for gaskets and seals that offer better performance than standard products, which are short-lived. It was our impression that you might already be supplying such high quality products to the U.S. robot industry.

We are Canada's largest supplier of rubber "boots" and bellows used on robot arms for dust protection. Our plant is well-equipped for the production of gaskets and seals, as well. Further information on our specific interests and capabilities can be found in the enclosed.

The possibility of our firms working together could be mutually beneficial and we would welcome your advice on this. In your reply, perhaps you could include pertinent data on your products in this area. We would also be glad to provide you with any further information you may require on our activities and capabilities.

Sincerely yours,

Enclosure:

EVALUATION

CRITERIA

It is impossible to set out a definitive list of desirable partner characteristics. Tastes differ and the ideal partner for one corporation might be a disaster for another. An examination of some of the considerations you should bear in mind upon the selection of a partner may, however, be a worthwhile exercise. These include the following:

- Compatible Cultures
- Corporate outlook policies, judgements, tempo of action
- Flexibility
- Financial goals

Once you have canvassed the sources of outside technology, a list of potential licensors should be drawn up. It is important to make effective contacts with sources of licensing opportunities you have found.

The criteria on which a licensee judges offers should be established before the offers are received. Such criteria is subject to change depending upon the dynamics of the business and the search environment.

CONDUCT OF A MARKET SURVEY

When a licensee is about to enter negotiations on licensing terms and conditions or when a decision must be made between several competing products or technologies, a market survey should be conducted.

See Appendix II-H.

RATING SYSTEM

A form should be established for systematically and fairly analyzing the good and bad aspects of each product or technology offer.

An example of a form used by an industrial products business with a successful record in producing new products under license is included as Appendix II-I.

APPENDIX II-H

Conduct of a Market Survey

The Customers

- What customer segments will be involved?
- What are the product requirements in each segment?
- What is the size and density of each customer segment?
- Who would be the major customers in each segment?
- What are the profiles of these customers?
- What is the personality profile of each market segment?
- What products will each customer segment want next year and five years from now?

The Competitors

- What are the existing competitive products in each market segment?
- Who are the existing major competitors?
- What are the competitors' Strengths?
- What are the competitors' weaknesses?
- What probable competitive products will enter the market after our entry?
- Who will be the probable future competitors within the next five years?

The Selling Environment

- What prices can be commanded in each segment for the products?
- What sales networks are available to penetrate each segment?
- What is the probable number of direct salespeople who will be selling our products in each market segment?
- What is the probable number of sales calls for each sales close?
- What is the probable percent of each salesman's effective sales time that we can command?
- What "image" is necessary to effectively penetrate each specific market segment?
- What customer education programs are essential for our market penetration?
- What sales personnel education programs will be required to realize greater market coverage?

What might be possible effective ways to ward off competition or sales hurdles?
What are the best advertising media for our use?

APPENDIX II-I

Sample Offer Evaluation Form*

Stability

Market life expectancy.

- Greater than 20 years.
- 10 to 20 years.
- 5 to 10 years.
- Less than 5 years.

Market distribution.

- Market covers a wide variety of industry.
- Market covers a reasonable number of industries.
- Market covers relatively few industries.
- Market is only in one industry.

Freedom from recessionary factors.

- Completely free.
- Relatively free.
- Tending towards.
- Completely prone to.

Imitation factors.

- Extremely difficult to copy.
- Rather difficult to copy.
- Fairly easy to copy.
- Can be copied by anyone with ease.

Patent protection.

- Good patents available or applied for.
- Patents have strong points and claims.
- Patents are of limited value.
- No patent protection or patents held by a competitor.

Product obsolescence factor.

- Long product life assured with few changes.
- Only minor changes required in lifetime.
- Some changes needed from time to time.
- Frequent changes required.

Marketability

Utilization of existing sales force.

- Sales force ideal from every aspect.
- Few adjustments required to sales force.
- Major retraining or regrouping required.
- Sales force completely unsuitable.

Company reputation.

- Highly beneficial in selling product.
- Will assist in selling product.
- Reputation of little value.
- Company reputation as exists of no value.

Help from existing product sales.

- Products are complementary and offer much help.
- Some assistance expected between products.
- Products completely different and little help.
- No help at all — possibly conflicting.

Ease of market penetration.

- Market is looking for new products.
- Good prospects of acceptance in market.
- Fair prospects of acceptance in market.
- Great difficulty in entering the market.

Possibilities for captive market.

- Almost certain possibility of captive position.
- Reasonable possibility.
- Slight possibility.
- No possibility.

Financial Factors

Average sales for initial five year period.

- Greater than 100% of those desired.
- 50-100% of those desired.
- 30-50% of those desired.
- Less than 30% of those desired.

Average sales price.

- Greater than 100% of that desired.
- 50-100% of that desired.
- 30-50% of that desired.
- Less than 30% of that desired.

Gross profit.

- Greater than 40%.
- 30-40%.
- 20-30%.
- Less than 20%.

Capital utilization as % of annual sales.

- Minimum capital investment required, less than 3%.
- Low capital investment required, 3-5%.
- Fairly high capital investment, 5-10%.
- Excessively high capital investment, 10+%.

**You should establish a weighting to suit your company.*

Growth Potential

Uniqueness of product.

- Totally unique.
- Many unique features.
- A few unique features.
- Same as any other product on the market.

Demand ratio.

- Market obviously undersupplied.
- Market tending towards undersupply.
- Market tending towards oversupply.
- Market oversupplied.

Market potential.

- Excellent growth potential.
- Good growth potential.
- Limited growth potential.
- No growth potential.

Potential governmental intervention.

- Almost no interference expected.
- Few interference factors expected.
- Some interference or regulation expected.
- High regulation and interference expected.

Positive Contributions

To existing product line.

- High contribution to major products.
- Some contribution to major products.
- Some contribution to overall or a few products.
- No contribution to products.

Engineering capability.

- High contribution expected.
- Adequate contribution expected.
- Low contribution expected.
- No contribution expected.

Company name and reputation.

- High contribution expected.
- Adequate contribution expected.
- Low contribution expected.
- No contribution expected.

Manufacturing

Utilization of company facilities.

- Facilities completely satisfactory.
- Some new equipment required.
- Extensive new equipment and facilities needed.
- New special machinery and/or trained labour required.

Utilization of existing suppliers/subcontractors.

- Facilities and capabilities fully adequate.
- Some changes required.
- Extensive changes required.
- New relationships required.

Degree of standardization.

- High degree of standardization possible.
- Some possibility for standardization.
- Few possibilities for standardization.
- No standardization possible.

Engineering and Research & Development

Utilization of existing personnel.

- Personnel are suitable in number and experience.
- Some retraining required.
- Considerable recruitment required.
- No suitable personnel available.

Know-How

- Exists in company and can be used.
- Possibly can be developed internally with outside help.
- Possibly can be developed jointly with outside help.
- To be bought from outside.

Utilization of R&D laboratories and test facilities.

- Facilities suitable with no alteration
- Minor modification required.
- Some modification required.
- New facilities required.

Availability of license.

- Suitable license available.
- Some difficulty expected in negotiation.
- Some doubt if license can be concluded.
- Serious doubt that license can be concluded.

Scope of technical development.

- Excellent possibility of spin-off for other new products.
- Good possibility of spin-off for other new products.
- Fair possibility of spin-off for other new products.
- No possibility of spin-off for other new products.

NEGOTIATION

The length of time required to negotiate a technology transfer agreement, the number of steps involved, and the manner in which the negotiations are conducted will depend on such factors as:

- The complexity and importance of the proposed agreement.
- The previous relationship of the licensee to the prospective licensor.
- The amount of explanatory research and planning done before opening the negotiations; and the time, money and personnel available for or assigned to the negotiations.

There are basically three stages in the negotiation of a technology transfer agreement:

1. Preliminary fact-finding and exchange of views between licensor and licensee.
2. Drafting of a proposal covering the major commitments of both parties.
3. Preparation and approval of a formal contract.

PRELIMINARY STEPS

Several important steps should be taken before or during the early contacts with the prospective licensor.

Ascertain the Financial Status of the Licensor

When you reach a point where you are confident about securing a license, you will want to further investigate the financial background of the potential licensor.

Dun & Bradstreet offers a credit reporting service. For a fee, they will furnish a credit report on a company. The report will include company sales, number of employees, balance sheet and income and expenses statement summaries, records of payments to suppliers, biographical information on directors, information on facilities occupied and their condition and a number of other useful bits of information. Normally, you need to be a subscriber to this service in order to receive these reports. However, your bank or consultant in Canada may be able to assist you with credit references.

Become Acquainted with the Licensor

Become acquainted with the licensor's management views, methods of operation, objectives, and expectations of performance standards and working relationships under an agreement.

Identify Your Advantages

There are a number of important advantages you can offer a potential licensor. Should a situation arise where you must convince a reluctant source to consider a licensing arrangement, you should be familiar with these advantages and be prepared to offer them in your favour:

- (a) You are located in a country with favourable wage rates. You can offer a possible alternative or supplemental source of supply for a licensor who may be losing his competitive position due to high wage rates in his particular sector of industry in the U.S. or elsewhere.
- (b) If the licensor is in an industry which is prone to frequent or prolonged labour strikes, being a licensee, you can offer a potential source of product even when his own facilities are not operating.
- (c) If your manufacturing volume expectations are modest in relation to the licensor's normal volume, it is possible that you could represent a potential purchaser of lower speed or capacity production equipment which the licensor may have been using and which he may wish to replace in order to become a more efficient producer in his own operations in the U.S. or elsewhere.
- (d) You can provide important feedback of both technical and commercial information and ideas from your own unique market. Being a truly local presence, you are able to provide this type of information without being hindered by language factors or a lack of understanding for local customs and regulations.
- (e) The license agreement may be the start of a relationship which may be expanded or strengthened, to include a joint venture on a more important project or technology or some form of eventual investment participation or

acquisition of your corporation (or the licensor's) if that is foreseeable.

- (f) As a licensee, you can explore the market potential in your corporation for the licensor, thus saving him money which would otherwise have to be spent at considerable risk to test and develop your market.

Identify Your Other Capabilities

In addition to these advantages, there are other capabilities that you can offer a licensor.

- (a) The technical contribution which you can make to improve on a licensed product or adapt it in a novel way to your own market.
- (b) The ability to set up the manufacturing capability for the licensed product in the shortest possible time.
- (c) The ability to minimize capital outlays in bringing the new licensed product on-stream, either through use of existing equipment and facilities or the clever acquisition of such capabilities.
- (d) Special know-how in quality assurance, high volume production, optimization of quality, etc.
- (e) Strong product development capability which can be used to build a line of complementary products around the licensed product.
- (f) A strong or unique capability to be able to either produce or market a large volume of the licensed product.
- (g) Particular strengths in terms of raw material availability, storage, shipping or other logistical factors.
- (h) Financial incentives offered by local government in terms of reimbursement for training workers who will produce the licensed product; loans at favourable rates to equip the plant for new production; tax deferrals and other subsidies offered by government to insure fullest employment.

THE NEGOTIATION PROCESS

While technology transfer negotiations may be conducted by correspondence or through an intermediary agency or representative, personal discussion and bargaining is generally the favoured method.

Negotiation in person leads to better understanding and rapport between the negotiating parties. Mutual respect and confidence is the key to the success of the technology transfer agreement.

It is useful to be aware of some of the more

common mistakes that can be made in negotiating a license agreement.

- Failure to "do your homework" (i.e., technology, product or company evaluation and market analysis).
- The inexperienced negotiator will tend to dismiss in advance any proposal or negotiating point which he thinks the potential licensor will object to.
- A timid, inexperienced or unknowledgeable negotiator will not want to ask the often difficult but necessary questions.
- Even though you have more excess plant capacity, do not let the licensor know that you are desperate to reach an agreement in order to keep your plant doors open. His demands may close the doors sooner than you had anticipated.
- Do not be so eager that you try to reach agreement by backing off from an equitable position in return for only short-term harmony.

PART III
MAKING THE DEAL



IMPLEMENTATION OF TECHNOLOGY TRANSFERS

Our objective in Parts I and II has been to encourage and guide the search for technology. The basic alternatives were mentioned earlier; outright purchase, licensing and joint ventures.

We now discuss implementation. We explore the general principles and typical choices available in the implementation phase, with emphasis on the transferee's perspective. We do not attempt to provide model agreements or contract clauses except for a few illustrations. A sampling of such material may be found in our work entitled "International Transactions" in Volume 3 of *O'Brien's Encyclopedia of Forms*, pages 257 to 504.

Bear in mind that when technology transfers are considered in detail, each transaction has unique elements. The variety of possible arrangements is limitless. It should not be assumed that a given set of factors will fall neatly into a pre-determined category for which a label and standard form documentation is available. Such thinking is likely to lead to insufficient analysis or inattention to detail. It must be taken as a first principle that the purpose and intention of the transaction should govern its form rather than the reverse.

NECESSITY FOR FORMAL DOCUMENTATION

While there is no general rule of law that technology transfers must be documented, to proceed with such arrangements without the legal safeguards provided by formal contracts is to court disaster. Prematurely implemented or inadequately documented transactions are among the most typical situations brought before courts for judicial determination.

This is not to ignore the usefulness of exchanging verbal or written proposals, memoranda, letters of intent or non-binding "heads of agreement". The essential thing is to remember that there is no definitive agreement, and withhold actual implementation steps, until the legal documentation has been prepared, agreed upon and executed.

The development of clear documentation is a

creative process stemming from the initial assessment of needs and goals, and subsequent interaction of the parties. It should be a team effort between the principals, whose business interests will be vitally affected, and their professional advisors. Some business people are prone to take the oversimplified view that once the elements of a proposal are submitted to counsel, proper documentation will more or less automatically result. This tendency should be avoided. While it is the duty of your lawyer to explore and resolve questions which arise in the drafting process, and to produce internally consistent documents, there is no substitute for careful study of intermediate drafts and completed contracts by the parties in interest. Documents which are not entirely clear and understandable are inadequate and should be reworked.

NONLEGAL ELEMENTS OF SUCCESSFUL TECHNOLOGY TRANSFERS

Mutual understanding and good faith may well be as important to the success of technology transfer arrangements as a comprehensive legal framework. If these elements are present, and the underlying agreement is basically fair to both parties, there is a strong likelihood that problems will be resolved amicably. Formal contracts and forms of business organization seem to work best when treated as a framework for a long-term, cooperative relationship. This is especially true in the case of international transactions, where cultural factors are often very significant.

Nonetheless, good faith is not a substitute for precise and comprehensive contracts which provide both the basic ground rules and the ultimate fallback position in the event of a breakdown in performance or communication. It is well to remember that written contracts are likely to remain long after the individuals who negotiated or initially administered them have left the scene.

"STANDARD" DOCUMENTATION

It is commonplace for a supplier of technology to submit copies of his "standard" documentation as soon as a serious intention to negotiate has been established. This practice is especially common in licensing and is discussed in more detail under that heading. The tactics of a technology supplier in proffering ready-made documents may be initially attractive to the recipient, who is inclined to see in it a gesture of acceptance and a straightforward method for moving ahead. If he lacks a secure strategy of his own, the other party's forms may appear as a life raft in a sea of uncertainty.

Needless to say, the party receiving "standard" documentation should proceed with caution. Careful business and legal analysis will reveal whether or not the document is satisfactory as a starting point. It is astonishing how often the proffered documents miss critical points of the particular transaction or contain language which is unsuitable because it was originally drafted for a different set of circumstances. Foreign documents may also contain extraneous material or fail to take into account important legal requirements of the domestic jurisdiction.

ROLE OF LAWYERS

Technology transfers usually require the assistance of legal counsel. Opinions differ as to the stage at which counsel should be introduced into the process. Some perceive the early involvement of lawyers in negotiations as tending to create an unnecessarily formal or adversarial environment. Others involve counsel at an early stage with a view to avoiding pitfalls and proceeding in an organized and efficient manner. Both views may be valid, depending on one's own experience and the role or roles counsel is expected to assume.

Our preference as legal advisors is to be made aware of an impending transaction at the earliest possible stage. Early consideration of basic guidelines, tax considerations, legal peculiarities of the foreign jurisdiction, currency exchange or investment controls can serve as excellent preventive medicine. We emphasize the need to consider the possible existence of legal factors in the technology supplier's own jurisdiction which might bear upon the transaction. In this connection, it is advisable to secure the advice of competent counsel in the local jurisdiction to advise on such factors and generally be available for consultation from the outset.

This does not mean that legal counsel need necessarily be present in the early fact-finding phase or preliminary negotiations. We strongly recommend, however, that counsel be involved at least on an offstage basis whenever documentation is being prepared which is capable of being later relied upon by one party or the other. This caution extends even to the purportedly non-binding letter of intent or heads of agreement, which may have more far-reaching effects than anticipated if not prepared with sufficient skill.

LICENSE OR JOINT VENTURE

In most cases, the basic implementation choice will be between licensing alone and some form of joint venture. While it is probable that a joint venture will include licensing as the framework for transferring technology from one or both parties to the venture, the elements of shared equity and management will largely determine their relationship and distinguish the joint venture arrangement from arm's-length licensing.

A comparison of licensing arrangements and joint ventures is set out on the next two pages. Bear in mind that the distinction may not be clear-cut.

COMPARISON OF LICENSING AND JOINT VENTURES

License Agreement

Joint Venture

Purpose

Licensee has existing or available products or facilities but requires technology, which may be acquired more cheaply or quickly from third parties than by internal research and development. Need may be limited in extent or duration.

Transferee has more comprehensive needs which may include capital, permanent injection of management or technical assistance and access to markets not available through licensing alone.

Licensor seeks exploitation of its technology in territories of secondary interest.

Transferor seeks direct entry into new markets; recognizes value of local participation. Government endorsement of foreign direct investment may be supported by a degree of local involvement.

Licensee seeks to maximize its own business by addition of new technology. If royalties are based on sales, licensor's interest is in maximizing sales rather than profits.

Joint venture partners have mutual interest in generating profits from the venture. Licensing arrangements may be present but incidental to joint objective of maximizing business profits.

Relationship of Parties

Parties deal at arm's length. Licensee exploits licensed rights and pays royalties. Licensee accepts conditions of use — including product and territorial limitations and possible restrictions on ownership and use of its own improvements.

Parties unite resources in a common enterprise to which both are committed on a continuing basis. Typically, one party provides technology, technical assistance and capital while the other provides basic production facilities, local marketing expertise, national identity and capital.

Parties remain potential competitors, subject to specific terms of licensing arrangement.

Competition is eliminated within the scope and duration of joint venture.

Benefits/Deficiencies

Initial outlay of funds is minimized for both parties.

Greater commitment of capital.

Licensee remains dependent upon his own infrastructure, including management skills.

Pooling of all resources of the parties may create a stronger economic unit than either could achieve independently, with only limited assistance from the other.

COMPARISON OF LICENSING AND JOINT VENTURES

License Agreement

Joint Venture

Purpose

Licensee remains free to manage its own business subject to restrictions of limited duration.

The parties are committed to co-operation and (usually) shared management. Some joint ventures fail because of differences in basic assumptions, management styles or competition for control.

Licensor has only indirect involvement in the markets to which the license applies and may not maximize profits.

Joint venture is a form of direct foreign investment for the foreign technology transferor. The local joint venture partner offers, among other things, knowledge of local markets, laws and customs and personnel adapted to the local environment.

Divides risk.

Spreads risk.

OUTRIGHT PURCHASE

The outright purchase of intellectual property is used infrequently as an alternative to licensing and joint ventures. When appropriate, it is the simplest mode of acquisition. The transfer documents need contain little more than an accurate description of the property being transferred, the price and terms of payment and language by which the transferor clearly transfers and warrants good and marketable title.

Assignments of registered rights such as patents, trademarks and industrial designs assume a fairly standard form containing all the requirements for registration in the appropriate government office. Agreements for the outright purchase of unpatented know-how are somewhat more complex because of the amorphous nature of the subject matter. The vendor may not ordinarily divest himself of all rights in know-how, but will either reserve rights of user in his own market or purport to sell the rights as they apply to the purchaser's territory.

It is obvious that this is no ordinary sale of property as understood in relation to tangible goods or real estate. There are some learned discussions in judgments of the Canadian and English courts, dealing with issues of taxation, as to whether or not know-how is "property" at all. For practical purposes it may be labelled as property, but its peculiar character must always be taken into account.

In what purports to be an outright sale and purchase, the buyer will undoubtedly extract covenants to the effect that the seller will not make further sales or disclosures to third parties or will do so only within certain limits. The buyer may impose on the seller additional duties to guard against unauthorized disclosure and assist the buyer to prevent or remedy unauthorized use or disclosure. In short, an agreement for the purchase of know-how will contain some of the same elements as a license agreement. The seller is likely to require reciprocal covenants from the buyer to protect his residual interest.

Some possible reasons for the relative infrequency of outright purchase as a method of acquiring technology are the following:

1. Owners of intellectual property rights are often simply unwilling to contemplate unrestricted divestiture. This is likely to be especially true of state-of-the-art technology.
2. Transferees seeking continuing technical assistance and/or rights to the transferor's improvements and future developments may find that outright purchase is not a sound basis for such an ongoing relationship.
3. Except in the case of mature technology with a history of market testing, the value of intellectual property is difficult to assess.
4. The purchase price is an up-front cost to the purchaser, unlike a rent or royalty based on user or a share of equity in the purchaser's business which costs him nothing in immediate monetary terms.

In other contexts, the outright sale and purchase of intellectual property rights is a common occurrence. The organization of an international licensing program may involve the outright transfer of intellectual property rights from the owner to a wholly-owned or joint-venture licensing subsidiary, which may be located in a low-tax jurisdiction. Again, when all the assets of an ongoing business are bought and sold, the purchaser usually obtains title to any intangible property rights of the business as well as to land, buildings and equipment.

LICENSING

CANADA IS ATTRACTIVE TO TRANSFERORS OF TECHNOLOGY

Canada is attractive to foreign licensors for a variety of reasons.

Licensing Not Regulated

Canada has no regulatory scheme governing licensing arrangements. In some countries, licenses are not valid until governmental approval or registration has been completed. Registered licenses may be available for public inspection. The potential foreign licensor is usually pleased to learn that Canada does not require any such registration or public disclosure.

No Investment Review

The Investment Canada Act, which establishes a review process for significant acquisitions of control of Canadian businesses, has no application to licensing unless it relates in some way to the control of a Canadian business enterprise.

Exclusive Licenses Permitted

Many countries impose restrictions on license agreements granting exclusivity in relation to products or territory. Such restrictions are based on the theory that such exclusivity may reduce competition or otherwise restrain trade. Canadian law addresses this subject by placing exclusive dealing, market restriction and tied selling in a category of reviewable trade practices.

Such practices are not prohibited outright and do not constitute criminal or civil offences. Where competition is likely to be lessened substantially because the practice is widespread or the supplier has a commanding position in the market, an order prohibiting the practices can be issued by the Restrictive Trade Practices Commission after affording the supplier a reasonable opportunity to be heard. Such prohibitions are extremely rare. The practical result is that, in the vast majority of cases, business considerations dictate whether the license agreement may provide for exclusive dealing, market restrictions or tied selling. This is an area in which a confirming opinion of legal counsel should be obtained.

No Exchange Controls

Canada does not have any exchange controls or other restrictions on the payment of royalties. Like most countries, Canada taxes royalty payments to non-resident licensors. The so-called "withholding tax" on such royalties is set at 25% in the Canadian Income Tax Act, but is reduced to 15% or less if the payment is made to licensors in any of the following countries with which Canada has entered into tax treaties.

Tax Treaty Countries

Australia, Austria, Barbados, Belgium, Denmark, Dominican Republic, Finland, France, Germany, Indonesia, Ireland, Israel, Italy, Jamaica, Japan, Korea, Malaysia, Morocco, Netherlands, New Zealand, Norway, Pakistan, Philippines, Rumania, Singapore, South Africa, Spain, Sweden, Switzerland, Trinidad & Tobago, United Kingdom, United States.

Freedom of Contract

Canadian license agreements are one variety of ordinary commercial contracts. As such, they benefit from the venerable principle of freedom of contract. The parties may, for the most part, create their own legal framework by the manner in which the contract is written. They will only be successful, of course, to the extent that the contract is clear and unambiguous.

The courts have created many rules to assist judges to arrive at some conclusions as to the intention of the parties where contract language is ambiguous or the written agreement fails to address a specific issue. Such judicial interpretations emerge as the result of litigation which is often long, expensive and not fully satisfying to either party. It does not provide an effective way for the parties to an ongoing business relationship to solve problems as they occur.

LICENSE AGREEMENTS

Point of Departure

While license agreements must cover such basic subjects as the rights granted, the consideration payable, and the duration of the arrangement, there is no definitive form. Our checklist is set out in Appendix III-A. We urge that it be taken only as a point of reference and not as a definitive statement of all points which may be covered.

"Standard" Forms

We noted earlier that some licensors develop forms which they designate as "standard". There are three basic situations in which such forms are offered.

1. The licensor, usually a large corporation with an extensive licensing program, administers the program by using comprehensive printed forms based on its years of accumulated experience. Space is left for identification of the licensee, and mechanisms are provided for the inclusion of items which vary from contract to contract, such as the definition of licensed rights, territory and royalty rates. Even these factors are in some instances invariable. In this context there is little room for negotiation of terms. Such forms are scarcely adapted to the requirements of a complex manufacturing arrangement where many individual items and the overall working relationship are likely to require custom-tailored treatment.
2. The licensor has had some experience with licensing, from which documentation designated "standard" has emerged. While there is much more flexibility to negotiate than in the first situation, the licensee may be expected to present its variations to the standard contract on an exception basis.
3. The document designated "standard" may in fact be nothing more than an adapted version of the contract which the licensor has most recently entered in another jurisdiction. In such a case, there is ample room for negotiation. The licensor may decide to counter with his own draft agreement.

The conclusion is that, if licensors' "standard" forms cannot be avoided altogether, they should be treated as a starting point for the process of formal documentation.

Licensed Rights and Products

Licenses deal with rights which fall within the broad and sometimes elusive category of "intangible" or "intellectual" property. There are many such rights, but those in which licensees are interested are patents and registered industrial designs, unpatented technology or trade secrets (often called "know-how"), trademarks and copyrights.

The particular rights in which a licensee is interested usually find concrete expression in a definable product. If so, it is useful in the license agreement to make reference to the product as well as to the underlying intangible property rights. "Licensed Product" will typically be defined to mean that product (possibly identified also by name, size, capacity or other characteristics) which incorporates in whole or part any of the inventions covered by the licensed patents or any elements of the licensed know-how.

Intangible property rights may be licensed separately. It is not uncommon to encounter a bare patent, know-how or trademark agreement, especially in the domestic context. International technology transfers more commonly involve a package of such rights. A brief discussion of patents, trademarks, industrial designs, copyright and know-how, taken separately, will give the reader some tools for dissecting and better understanding such a potentially confusing hybrid arrangement.

PATENTS

Patents are limited monopoly rights created by a government which confer on the owner the right to exclude others from making, using and selling the invention. A licensee must therefore obtain rights for each country in which he wishes to manufacture or sell products incorporating the patented invention. Merely by granting a patent license, the

patent owner does not technically convey anything but agrees, within the terms of the license agreement, not to exercise the right he would otherwise have to sue the licensee for infringement.

For practical purposes a patent license is treated as limited transfer of property for the life of the patent or a lesser defined term. In Canada, a patent has a life of 17 years from the date of grant. Since patents contain a disclosure of how to practise an invention, they do not enjoy continuing protection as trade secrets after the term of protection expires.

"Licensed Patents" will typically be defined in the license agreement to mean those patents listed by number and country on a schedule and any patents issuing from similarly listed patent applications. This definition may also be extended to include patents later applied for which constitute improvements or in some other way are related to those previously referred to. Whether or not the scope of the license extends to improvements or related inventions is an important planning and negotiating point to which we shall return.

The Canadian Patent Act requires exclusive patent licenses to be registered in the Patent Office. However, no consequences result from failure to register, and in practice, such registration is the exception rather than the rule.

TRADEMARKS

Registered trademarks are similar to patents in that they are limited monopoly rights protected by legislation.

A trademark must be registered in Canada before the mark can be validly licensed in Canada. An application for registration can be based on use or making known, or on proposed use of a trademark in Canada or on use and registration of the mark in the licensor's home country. If an application is based on proposed use, actual use of the trademark in Canada must begin before registration will issue. This use can be exercised by a licensee.

An important but often overlooked matter is that a Canadian trademark registration can be invalidated if the trademark is used by a licensee without formally recording the licensee as a user of the trademark in the Canadian Trade Marks Office. All licensees of a trademark must therefore be recorded as registered users of the trademark. The principle of user registration is strictly enforced by Canadian courts and applies equally to subsidiaries or related companies of a licensor.

Registration is simple and inexpensive. A short "registered user agreement" containing pertinent details, including provision for quality control by the licensor, can be registered instead of the entire license agreement.

In Canada, title to registered trademarks may be preserved indefinitely so long as use of the mark continues and renewal is effected every 15 years.

INDUSTRIAL DESIGNS

Like patent and trademark rights, rights to an industrial design are created by statute. An industrial design is any original shape, pattern or ornamentation applied to a manufactured article such as a table shape or fabric pattern. An industrial design must be filed and registered within twelve months from the date of its first public disclosure in Canada. Registration is valid for five years from the date of registration and may be renewed for one further five-year term.

Licenses of industrial designs must be in writing but need not be registered. The Canadian Industrial Design Act requires that articles incorporating a registered design bear the name of the registered owner, the letters "Rd." and the year of registration of the design. If the article is physically difficult to mark, the information can be on an accompanying label.

COPYRIGHT

In Canada, copyright exists in original musical, dramatic, artistic and literary works (including computer programs) and in records and other means by which sounds are mechanically reproduced. In most cases copyright subsists for the life of the author plus 50 years. Copyright arises from creation of a work and does not depend on registration pursuant to the Copyright Act although registration creates certain presumptions in favour of the registered owner and facilitates the collection of damages against infringers. An application to register copyright in a work may be filed at any time during the term of its existence. Canada is a member of the Berne Convention for the protection of copyright internationally and since 1988 has granted authors limited "moral rights" which survive the assignment of copyright but can be waived. Some aspects of copyright protection may be lost where a work is capable both of copyright and industrial design registration. In such cases industrial design protection should be sought without delay.

UNPATENTED TECHNOLOGY OR "KNOW-HOW"

Unlike patents, trademarks, industrial designs and copyright, there is no statutory protection for know-how. The licensor is protected in relation to the licensed know-how only by the terms of the agreement. In spite of this apparent "softness" in its legal status, know-how is very often the most valuable element in a license. At the least, it tends to enhance the value of other licensed rights. Reciprocally, the contemporary licensing of patents, industrial designs and trademarks tends to provide the licensor with a statutory basis for exercising some control over the use of the licensed know-how.

Defining the "Licensed Know-How" in a particular license agreement may be a demanding task. It is scarcely sufficient to refer, in circular fashion, to "all the data that are or will be provided by licensor to licensee under the agreement". The task is to design a definition which expresses the intention of the parties sufficiently to allow them to work out the technology transfer without including exhaustive detail or full disclosure in the agreement itself. The following examples from actual agreements are indicative of the approach.

"Know-How" Sample Definitions

"Licensed Know-How" means the accumulated knowledge, experience and information relating to the design and manufacture of product which on the effective date of this agreement the licensor has in its possession including, without limitation, unpatented and unpatentable discoveries, inventions, processes and formulae and technical data such as drawings, designs, blueprints, plans, specifications, material lists and catalogues; process descriptions; operation manuals, engineering, technical and scientific reports; and economic studies and reports.

"Licensed Know-How" shall mean all information and technology, written or unwritten, patentable or unpatentable, owned by Licensor now or developed by Licensor during the term of this License Agreement, relating to the development, use, manufacture and sale of Licensed Products including, without limiting the generality of the foregoing:

- (i) all basic design data including design drawings;
- (ii) all specifications relating to manufacture and performance; and
- (iii) all test data and projections.

"Licensed Know-How" shall mean technical facts, data or advice, written or oral, in the form of reports, drawings, manuals, specifications, bills of materials, photographs and the like, relating to a product system or any of its components and processes, compositions or articles of manufacture and apparatus utilized on a commercial scale by either of the Licensors in their manufacture, fabrication, testing, packaging, marketing and filed installation of a product system or any of its components in the regular course of their business throughout the term of this Agreement; provided, however, that the Technical Information shall not include any of the following: (specific exclusions omitted)

Strictly speaking, the know-how which a licensor has the right to license, and for which fees are properly paid, is know-how of a specialized, secret and proprietary nature. The licensee is at liberty, quite apart from the license, to use any industrial know-how which he finds in the public domain. For this reason, agreement definitions usually make reference to the special secret and proprietary nature of the know-how which is being licensed. The term "trade secrets" is sometimes used to emphasize these characteristics.

The distinction between public and proprietary know-how is not always clear, and to avoid such a distinction some license agreements will focus on the end product as well as the know-how required to produce it. The licensee should receive the right, among others, to manufacture, use and sell specified products of the licensor's design, incorporating its patented inventions or made to its specifications.

DESCRIPTION OF THE PARTIES

It is said that the essential elements of any contract are the parties, the property and the price. A clear and correct description of the parties to a license agreement is indispensable. Corporate names should correspond exactly with the names shown on incorporating documents. A division of a corporation cannot be party to a contract. A common and useful practice is to identify, along with the corporate name of each party, its incorporating jurisdiction and principal place of business.

THE PREAMBLE OR RECITALS

Recitals provide an opportunity to set the stage by describing the parties, their purpose in entering into the arrangement and their respective roles. Definitions and schedule references may appear in these recitals or be held in reserve for a separate "definition" section.

DEFINED TERMS

We have referred to the practice of developing defined terms such as "Licensed Product", "Licensed Patents", and "Licensed Know-How" for the purposes of a particular agreement. The use of such terms may appear formalistic and awkward until one becomes accustomed to it. It is, however, an excellent device for simplifying complex documents. Defined terms should be carefully chosen and consistently used. The kind and number of terms defined will vary from one agreement to another. As noted earlier, the basis on which royalties will be calculated is ("Gross Sales", "Net Sales", "Net Profits") and territorial coverage of the agreement ("Territory"). The period for which the license is intended to be in force may be called the "Term". Indeed, it may be useful to distinguish between the "Initial Term" and a "Renewal Term". Such terms can be "invented" whenever they would appear to serve a useful purpose.

USE OF SCHEDULES

The appended schedule, sometimes referred to as an "exhibit" or "appendix", is another device for achieving clarity and simplicity. It allows for the segregation of property descriptions and excessively technical details such as royalty escalation formulas and minimum sales requirements so that the body of the agreement can focus on its basic intent.

THE GRANT

Broadly speaking, a license agreement embodies a licensor's commitment to grant license rights and a licensee's reciprocal commitment to use such rights under the restrictions described in the agreement and to pay royalties. The grant therefore lies at the heart of the agreement and usually appears as the first operative clause following the definition of

terms.

Assuming that the license agreement covers all the forms of intangible property, the essential elements of the grant may be summarized as follows:

Right to use licensed patents, trademarks, industrial designs, copyrights and know-how;

Right to manufacture products embodying the patents, industrial designs and know-how and/or products of the licensor's design as defined in the agreement;

Right to sell such products.

A number of questions immediately arise. Where may each of the rights be exercised? Are they exclusive or not and, if so, does the licensor exclude himself as well as agreeing not to license third parties? What about the licensee's right to sublicense others? These questions may be resolved within the grant clause itself or under separate headings.

GEOGRAPHICAL LIMITATIONS ON LICENSEE

Licensors usually protect themselves against competition at home and in other major markets in which they are active by confining the exploitation of licensed rights to a defined territory. They may also be under contractual obligations to protect their other licensees. Licensees, on the other hand, seek to obtain licensed rights in order to increase their own sales and profits and consequently have an interest in exploiting such rights in as much of their actual or potential market area as possible. Different considerations may apply to geographical limitations on (i) manufacturing, (ii) selling, and (iii) sublicensing.

Depending on the cost of transportation for products, restriction of manufacturing to Canada may be acceptable to the licensee. Restriction of sales to Canada is likely to be less acceptable. Such restrictions should not be accepted without full consideration of the long-term consequences and exploration of the licensor's degree of flexibility. The licensee may otherwise obtain access to foreign technology through licensing to increase the speed and reduce the cost of product development, or to increase productivity through diversification, only to find that his ability to reap the rewards of success is seriously limited by market restrictions.

One avenue the prospective licensee may explore to strengthen his negotiating position is to examine the anti-trust laws of the licensor's home

jurisdiction. Nations frequently purport to regulate the behavior of their nationals beyond their own territorial boundaries to prevent behavior which may have an internal domestic effect.

The United States and the Western European nations of the European Economic Community all purport to exercise such jurisdiction over practices in restraint of trade or monopolization in export commerce. Practices such as export combination, exclusive dealing, price fixing, resale price maintenance and market allocations may all be caught under the extra-territorial enforcement of such legislation.

The vigor with which such laws have been enforced has led some countries to enact legislation which limits or "blocks" the effect of such legislation. Canada has considered but never adopted such "blocking" legislation. As a result, a prospective Canadian licensee should be aware that such legislation may well restrict the licensor's ability to require its licensees to enter into agreements containing what may be considered restrictive trade practices in the licensor's own country.

EXCLUSIVITY

Canadian licensees should seek to negotiate exclusive rights to manufacture and sell in Canada and other desirable markets not serviced by the licensor and non-exclusive rights to sell in other markets or on an unrestricted basis. Flexibility may be provided by leaving the agreement silent on the matter of export sales. Unfortunately, domestic market exclusivity and territorial marketing restrictions often go together. If this is so, a potential licensee might well consider forfeiting the advantages of exclusivity in order to secure wider market flexibility. At the least, the Canadian licensee should ensure that any limitations on sales outside of a defined territory apply only to products incorporating the licensed rights.

RIGHT TO SUBLICENSE

Whether sub-licensing will be sought or allowed, and under what circumstances, will vary greatly from one situation to another. Licensors may look upon a grant of sublicensing rights as a means of promoting wider exploitation of the license rights or as a dangerous further dilution of the licensor's control of his intellectual property. The licensee may seek the right to sublicense to permit him to

subcontract the construction of components or to move manufacturing closer to markets within his territory.

Earlier comments regarding the need to record all users of a trademark in the Canadian Trade Marks Office apply as well to sublicensees. Failure to officially record a sublicensee may invalidate a trademark registration. In theory, trademark sublicenses as such are not registrable. Some device must be found for the sublicensee to receive a grant of trademark user privileges directly from the registered owner.

DURATION

The parties to a licensing arrangement commit themselves to a continuing relationship which involves both substantial advantages and onerous obligations. Terms relating to duration are among the most critical. Often, both parties are seeking a congenial, long-term arrangement. Occasionally they are prepared to contract absolutely for a long period of years or for a license in perpetuity. More often, a system is established for periodic review.

A common practice is to define an initial term with automatic extension for one or more renewal terms unless within some specified time or prior to an expiry date, one party gives the other written notice of its intention to terminate. Automatic renewal may only be effective if certain conditions in the original license have been satisfied. A variation is to specify a term with a provision that, at its conclusion, the parties will enter into good faith negotiations with a view to renewal. These devices establish a framework for continuity but do not give either party an assurance that the license will extend beyond the specified term.

Frequently the interests of the parties in relation to duration differ. The classical case is that of the licensor for whom the license is a preliminary step in a long-term strategy for direct involvement in the licensee's territory. In these circumstances the licensor may offer a shorter license term than the licensee is prepared to accept. The reverse situation may exist where the licensee is seeking outside technology essentially to shorten development time or to overcome a particular technological problem. When these objectives have been realized, he may no longer need a license and wish to be free of the royalty payments, market restrictions, feed-back licensing arrangements and other obligations. Heavy start-up and maintenance costs on the part of the licensee will necessarily militate in favor of a longer license term. Long-

term business strategy must invariably be taken into account.

The license agreement will provide for premature termination either automatically, upon the happening of certain events such as the bankruptcy or insolvency of one of the parties, or at the option of one party in the event of specified defaults by the other. Such events may include a failure by the licensee to make prompt payment of royalties or failure by the licensor to deliver updated technology or the technical assistance contracted for.

An often unnoticed or underestimated hazard for licensees in today's environment is the rapid pace of technological change. A long-term licensing arrangement, particularly one which provides for substantial minimum royalties, will prove onerous if the licensed technology becomes obsolete. This observation emphasizes the necessity for extreme care in selecting the licensed technology.

GRANT OF RIGHTS IN LICENSOR'S FUTURE IMPROVEMENTS

One of the fundamental choices in licensing is whether or not downstream refinements or improvements made by the licensor will be included in the grant. Once the choice is made, it may be reflected merely in the definition of the licensed rights or in more specific contractual provisions. Rights to future technology may take the form of an option to acquire or right of first refusal rather than an automatic inclusion in the original grant. They may be exclusive or non-exclusive.

The inclusion of future rights provisions in the license agreement may appear to represent an unmitigated benefit to the licensee. Indeed, in many instances such provisions are considered indispensable to achievement of the licensee's goals. The majority of license agreements which we have prepared or reviewed contain such provisions.

The recipient of a future rights clause may have difficulty in resisting the licensor's request for a "flowback" clause granting the licensor rights in the licensee's related research and development. Flowback provisions may act as a deterrent on the licensee's own research and development. The grant of future rights also strengthens the licensor's hand in negotiations for manufacturing location and market restrictions.

Potential licensees should be prepared for

negotiating positions reflecting these tradeoffs. It may be of interest that according to recent research, "diversified" licensors, those companies whose sales are composed of numerous unrelated or loosely related products, impose fewer license restrictions than "dominant product" licensors, whose sales for the most part relate to a single or related products, even when rights to future technology are granted.

Future technology grants may carry a price in terms of royalty rate, but there is reason to believe that this is less common in practice than might be supposed. If the price of future technology, whether in financial terms or trade-off concessions, is too high, the licensee faces the choice of refusing the license rights offered or resolving to license current technology only and compete with the licensor in maintaining and improving the licensed technology.

FLOWBACK AGREEMENTS

Reference has been made to "flowback" clauses whereby some benefit of improvements made by the licensee revert to the licensor. A common negotiating position on the part of licensors is to demand that improvements to the licensed technology made by the licensee automatically become the property of the licensor or, at the licensor's option, become available to the licensor on an exclusive, royalty-free basis. The inclusion of such a clause is not invariable. Licensees may negotiate to license their improvements in the licensed technology to the licensor on an exclusive or non-exclusive basis at an agreed royalty rate. A "grant back" to the licensor may extend beyond the term or territory of the original agreement.

ROYALTIES

Licensing is characterized by the royalty form of payment. Royalties are periodic payments based in some manner on use of the licensed rights.

The relationship of payment to use can be established in a variety of ways. Probably the simplest form of royalty, frequently seen in the recording and book publishing industries, is the fixed amount per unit sold. This formula may be appropriate where the product can be clearly identified and the royalty applies to limited quantities or for a limited period of time. It is not

usually a satisfactory approach in an industrial context. Some of the alternatives are discussed below.

1. Percentage of Sales

The most common form of royalty mechanism is the percentage of gross or net sales, sometimes prefaced by one or more lump sum payments which serve as earnest money and as a contribution to the licensor's costs of negotiating the arrangement and implementing the initial transfer. The rate of royalty may be fixed or variable. For example, the rate may progressively decrease as various levels of sales volume are attained. Such graduated rates enable a licensee to reduce the impact of royalties while providing him with an incentive for maximizing volume.

The "royalty base" should be well considered. A simple reference to "gross sales" may sometimes suffice, since gross sales figures can ordinarily be determined by inspecting the licensee's accounts. However, a more common practice is to refine the definition by identifying ways in which the gross sales figure is to be adjusted before royalties are calculated by applying the royalty rate. Such adjustments may include the deduction of such items as commodity taxes, customs duties, commissions, trade discounts, packing charges, transportation charges or insurance costs. The result is a "net sales" figure. Use of a defined term to describe the royalty base can simplify the vital royalty payment clauses of the license agreement.

Various devices may be used to guard against contingencies. For example, the licensor may insist that the initial "sales" figure be based on published price lists or other evidence of "fair market value" to guard against a dilution of royalties when the licensee sells at discounted prices.

2. Royalty Based on Production

In some instances, the sale price of goods sold may not be considered a sufficiently accurate measure of technology use. One alternative is to calculate the royalty as a fixed amount per unit of product manufactured or by reference to weight, volume or other indicators of output. A production basis favors the licensor because royalties are calculated at an earlier point in the industrial cycle and paid in respect of stockpiled inventories, (which may become obsolete), products or components used by the licensee, and returns from purchasers.

3. Percentage of Net Profit

Royalties based on licensee profits are rare. Their

use implies substantial licensor confidence in the licensee's manner of exploiting the licensed rights and accounting for profits. This method usually requires a detailed understanding as to the manner in which profits will be calculated. This may be difficult since the licensee's operations under the license may not represent his entire business undertaking, and in practice, profits are not always calculated on a product line basis.

The use of profits as a royalty base tends to move the arrangement into a hybrid category midway between licensing and joint venture, as the licensor is likely to feel impelled to take a more direct interest in management of the licensee's business to protect his notional equity.

4. Lump Sum Payments

A predetermined lump sum payment is not considered to be a royalty in the true sense, even if payable by instalments, because the amount is not related to use. For the limited purpose of charging the licensor a withholding tax, some such payments may be brought within the meaning of royalty as noted elsewhere. In rare instances lump sum payments may be appropriate to the circumstances. Certainly they are simpler than any other form of consideration for intellectual property rights from an accounting point of view. Presumably the amounts will be based on pre-estimates of sales on profits.

5. Payment-Free Licenses

The licensor's motive in granting license rights may not always be to earn a monetary consideration. Licensor and licensee may enter into a complete crosslicensing agreement, for example, whereby each becomes entitled to utilize the technology of the other in a specified territory without additional consideration. The motive is to promote an active, ongoing two-way flow of data.

Determining the Royalty Rate

Having decided upon an appropriate royalty base, the parties must agree upon a rate. There are no hard and fast rules governing royalty rates. This is because there is rarely a clearly-defined market for intellectual property as there is for most tangible products.

It is usually the licensor who opens negotiations by suggesting a royalty rate. Many licensors rely primarily on more or less established industry norms. This is especially true where the technology is mature and relatively homogenous.

The licensor's perspective may reflect his research and development expenditures or the anticipated profits of an alternative investment.

These are factors peculiarly within the knowledge or perception of the licensor and consequently may not be openly disclosed in negotiations with the licensee.

A more objective approach is to estimate how the royalty will effect an allocation of actual profits from exploration of the licensed rights. Curiously, in practice, parties to a proposed license rarely make in-depth studies of this factor.

Basically, the process of fixing royalty rates is one of negotiation, with each party making its own analysis as to the value of the transaction. It might be imagined that the licensor is likely to have a carefully considered position and a narrow range of flexibility with respect to the negotiation of royalty rates. Surprisingly, experience as well as published research indicate that the range is much wider than might be expected.

Other Issues in Writing Royalty Clauses

Depending on the royalty base selected, it may be important to identify the point at which an item is considered to have been manufactured or at which a sale has occurred and the time at which the obligation to pay the royalty arises and method of payment.

Royalty clauses become more complex when different calculations are required for the various rights granted. In some instances, a different royalty base or rate may apply to patents than to trademarks or know-how. We favor a global royalty calculation where possible, but any arrangements which rationally reflect the business interests of the parties can be documented.

Royalty Escalation Clause

The licensor may take the position that lump sum payments, minimum royalties, minimum sales quotas and other payments and obligations of the licensee should be subject to an escalation clause based on fluctuations in some published index, such as the Consumer Price Index. Invariably such clauses are initially proposed for the benefit of the licensor. Since the licensor is primarily interested in upward adjustment, licensees who find they must accept escalation clauses should ensure that downward fluctuations are also adjusted to their benefit.

A licensee's right to renew the license for a further term may also be based on minimum sales quotas as adjusted by fluctuations in the Consumer Price Index. Such terms are common in license agreements in the clothing industry. Fluctuations are usually taken into account in multiples of 10% from a defined base point.

Other indices are used in various industries. Such indices have common characteristics, including publication to the public on specified intervals and compilation by a neutral party, such as government or an industry association.

Designation of Currency for Payment of Royalties

Today, wide fluctuations of monetary exchange rates are prevalent. In most license agreements, the licensee is obliged to pay royalties to the licensor in the domestic currency of the licensor. It is commonplace for the parties to agree that conversion to the currency of payment must be at the rate of exchange on the due date of payment, tied to an internationally recognized and published exchange rate or based on the average exchange rate for a specified period. An alternative is for payments to be made in a relatively stable currency such as United States dollars although this is not common. The most favorable position for the Canadian licensee is for payments to be calculated in Canadian dollars since this is the currency in which his sales and profits are calculated.

MINIMUM PERFORMANCE REQUIREMENTS

In the interest of exploiting the license potential to its fullest capacity, the licensor will demand that the licensee use his best efforts to create and supply the most extensive market possible for licensed products. Having foregone the opportunity to sell his products in the licensee's territory, the licensor will require some reassurance that the licensee will work the licensed rights. In addition, world-wide promotion may be supported by sales and advertising in the licensed territory. Home country legislation may also require working of the licensed technology to preserve the licensor's monopoly.

Imprecise "best efforts" provisions may not provide enough protection for the licensor, who may require that the licensee meet minimum sales standards or quotas. Such minimums may relate to royalty payments or unit sales volumes but can include the employment of named personnel or fixed expenditures for advertising and promotion. In this regard, royalty incentive clauses are common and may result in lower royalty payments at specified sales achievement levels.

The question then arises: What will be the consequences of a failure to meet minimum requirements? An obvious choice is termination of

the agreement. Mere termination, however, may not serve the licensor's purpose but merely leave him with neither licensee nor compensation for the licensee's failure to perform. Some alternatives to termination are the licensor's re-entry in the market territory, conversion of the license from exclusive to non-exclusive or a reduction in the size of the licensee's territory.

LICENSOR AS COMPONENT SUPPLIER

The supply of key components by the licensor may benefit both parties. To the licensor, it is likely to be an additional source of revenue; to the licensee, an economical source or possibly his only source. On the other hand, the interests of the parties may diverge, as when the licensee finds alternative domestic or other sources or becomes capable of manufacturing components previously purchased. Contractual provisions on this subject usually provide for close consultation and may merely establish general intention and a framework of price and delivery terms for supply arrangements to be negotiated in more detail from time to time. In some cases the purchase components or raw materials may be optional with the licensee.

The sale and purchase of components may have an impact on other aspects of the agreement. For example, achievement of specified purchase levels may reduce minimum royalties.

Remember that "tied sales" are a reviewable trade practice (refer to page 42). It is advisable to obtain a legal opinion that such an arrangement is permissible.

Production Machinery

The licensor may also be the best source for specialized production of machinery required at startup or be in a position to introduce the licensee to its suppliers. Prospective licensees should anticipate their needs and include this item in their negotiations.

PROTECTION OF LICENSED RIGHTS

Licensors are concerned to protect their intangible property rights against both the licensee and third parties. However, such protection is not solely a licensor concern. The licensee also has an interest in maintaining a relationship of trust and confidence between himself and the licensor and in that context

in reassuring the licensor that the latter's underlying property rights are secure. Licensor and licensee have a common interest in protecting the licensed rights against incursions by third parties.

Protection of Licensed Rights Against Third Parties

Since the title to licensed rights remains with the licensor, it is his prerogative to take legal action against interlopers. He will ordinarily have an interest in doing so. However, the licensor's level of commitment to an aggressive program of protection may be lower than the licensee would desire. The licensor, after all, is located some distance away, and his economic interest in the sale of licensed products in the licensee's territory is only indirect. Moreover, the protection of intangible property rights can be an expensive and frustrating process involving many judgment calls.

Licensors may nevertheless attempt to retain the option of deciding whether or not an action for infringement of the licensed rights will be initiated. It is not uncommon to see license provisions to the effect that the licensee is responsible for costs in the event of such proceedings with damages in the event of success going in whole or in part to the licensor. Licensees are well advised to negotiate vigorously for fair and balanced treatment on these issues.

There are several ways of dealing with these matters. While an action for infringement must be conducted in the name of the licensor, actual carriage may be undertaken by either party or as a joint endeavor. The parties should anticipate their needs and clearly express their intentions. The agreement should also allocate responsibility for the expenses of litigation and entitlement to any damages which may be awarded. These points are not exhaustive of the subject. The most critical term from a licensee standpoint is the right to commence legal action in the name of the licensor to protect the licensed rights if the licensor is unwilling or unable to do so.

TITLE RETENTION AND ACKNOWLEDGEMENT OF VALUE

Most licensors insist on a clause in the license agreement which provides that licensed rights remain the property of the licensor and that the licensee will at no time dispute his licensor's title.

Recently, licensors have also begun to demand that the licensee acknowledge the trade information of the licensor is a valuable asset and that any breach of the secrecy provisions by the licensee will result

in damages to the licensor. The insertion of such a clause precludes a licensee from asserting that the know-how of the licensor was of little or no value and facilitates a claim for substantial damages.

CONFIDENTIALITY REGARDING KNOW-HOW

A licensee will ordinarily be required to agree not to disclose the information, know-how or secret processes he acquires from the licensor except as necessary for the proper manufacture or distribution of the licensed products. In order to protect confidential information, the licensor sometimes demands that the licensee extract from each employee, sublicensee and subcontractor an equivalent undertaking of secrecy and confidentiality.

Some trade secrets may be disclosed before a formal license agreement is entered into. In projecting the feasibility costs and potential profits under a licensed operation, the licensor may reveal practical know-how including, in many cases, specifications, blueprints and cost data. This is ordinarily done after the licensor is comfortable concerning the general integrity and good faith of the potential licensee. The possibility, however, that negotiations will break down after valuable know-how has been disclosed has led some corporations to follow a practice of requiring the potential licensee to sign a brief preliminary agreement which makes it clear that:

1. the specifications and other know-how are being supplied for negotiating purposes only;
2. information is and will remain the property of the licensor;
3. the information will not be used in any way contrary to the licensor's interest;
4. copies or extracts of the information may be made only with the express consent of the owner; and
5. such information must be returned to the licensor on request.

Confidentiality obligations are usually intended to extend beyond the life of the license agreement. In addition to the obligation to return all technical information and data to the licensor on termination, the licensee may be required to agree not to reveal at any time, before or after termination of the license agreement, any information acquired as a result of the license relationship.

QUALITY CONTROL

Quality control commitments may be relatively unimportant in a bare patent license, but they are a major concern in more complex licensing arrangements where both parties may have a vital interest in preserving goodwill and the international reputation of the licensed products.

If the licensee's output is to be identified with the licensor's own products or corporate name, the licensor will insist that the licensee maintains quality standards that do not detract from its reputation or the goodwill and market acceptance that has been built up in world markets. Where trademarks are not involved, a licensor may not insist on strict adherence to its domestic designs and specifications. This will depend on its general marketing policy.

Quality control clauses generally include the following obligations:

- to manufacture licensed products in accordance with standards, specifications and manufacturing directions supplied by the licensor;
- to provide the licensor periodically with samples for inspection;
- to make promptly any such changes in the products, manufacturing procedures or raw materials used as the licensor may reasonably request; and
- to permit inspection by the licensor of the licensee's manufacturing and warehousing facilities.

COMPULSORY LICENSING

A patentee's monopoly is subject to certain conditions. A patentee may not abuse his rights, for example, by not working his invention in Canada within three years of its issuance or by using his patent to lessen competition outside the patent monopoly. Such abuses can result in the granting of a compulsory license to a third party to work the patent.

Compulsory licenses are also granted, almost arbitrarily, to qualified applicants in respect of patents relating to food and medicinal preparations. There is no need for an applicant seeking a compulsory license for these types of patents to demonstrate previous patent abuse. The Canadian government believes that the availability of compulsory licensing in the food and drug areas is necessary to ensure competition in these industries, thereby resulting in better access and lower prices to the public.

MOST FAVORED LICENSEE CLAUSE

Some circumstances may lead the licensee to negotiate for a most-favored-licensee ("MFL") status. This means that the licensee becomes entitled to the most favorable rate of royalty which the licensor grants to any of its licensees, although it may also apply to other terms. We have found such clauses to be the exception rather than the rule.

Generally speaking, the type of situation which best lends itself to MFL treatment is one in which the technology being licensed is part of a standardized package of technology whereby equivalent licenses are granted to many licensees. It is only where the grants are equivalent that it is possible to compare payment of royalties.

This book is primarily directed to those whose licensing arrangements are likely to be custom-tailored to satisfy specific requirements. One situation where the MFL clause may be a necessity is where the licensee has agreed to a non-exclusive grant. In this case, the licensee will need such a clause to guarantee his ability to compete on an equal basis with other licensees or the licensor itself. Without such a clause in the licensee's agreement, there is no obligation under Canadian law to oblige a licensor to charge the same or even substantially the same royalty to every licensee.

MFL clauses may be made to apply not only to future license arrangements entered into by the licensor but also to licenses previously granted.

APPLICABLE LANGUAGE

In an international license agreement, it may be advisable to provide that the version of the agreement in a certain language is the official copy of the agreement and the one that will ultimately govern the rights of the parties. Many international license agreements provide that the English language version of the agreement is the official version.

ASSIGNABILITY

The question whether the licensee may freely transfer the license to another party deserves more attention than it usually receives. Almost invariably the licensor wishes to limit assignability of the license by insertion of a clause providing that the rights granted may not be assigned or

transferred without the licensor's prior written consent. A supporting clause may state that any attempted assignment without such consent is to be void and shall have the effect of automatically terminating all the rights of the licensee under the agreement. Denial of the right to assign may not be indispensable in every set of circumstances. A standard ploy which the licensee may introduce in an effort to reach middle ground is to leave the consent clause as written but add that the licensor's consent is not to be unreasonably withheld. This provides the licensee with an opportunity to contest the objective reasonableness of a licensor's refusal to consent before a court.

OFFICIAL NOTICES

The names and addresses to which official notices under the license agreement are to be directed should be clearly stated. The common alternatives for delivery of such notices are prepaid mail, telex, or personal delivery.

The parties must decide on method of establishing the date of receipt of the notice. For example, if service is by mail, the receiving party may be deemed to have received the notice a given number of days after the notice was posted, in the case of a telex, when the sender receives the answerback code or in the case of personal delivery, on actual delivery.

As postal interruptions are increasingly commonplace, some parties insert provisions that in the event of an interruption of mail service, all notices are to be delivered by telex or personal courier.

TECHNICAL ASSISTANCE

NATURE OF TECHNICAL ASSISTANCE

Technology transfers can rarely be implemented effectively by mere transmittal of documents or other material. Some direct personal interaction of the technical personnel of transferor and transferee is likely to be required. Sometimes the transferor's assistance may extend to various aspects of management or accounting. The transferee should be alert to his needs for such assistance and ensure that the documentation makes adequate provision for it on acceptable terms.

Technology Transfer May Be Structured as Technical Assistance

Occasionally, the entire transfer arrangement takes the form of technical assistance. In such cases, a lump sum payment may still be exacted, but ongoing payments will relate to individual time inputs or achievement of definable implementation objectives rather than use of licensed rights. This arrangement may be suitable for the transfer of technology to a joint venture in which one party supplies technology as the basis for his equity participation. Although not seeking to exact a continuing royalty, he may wish to be reimbursed for the expense of diverting part of his labor force.

Technical Assistance Usually Provided Under Separate Agreement

Technical assistance clauses may be included in the license agreement, so that the document itself may be entitled "Licensing and Technical Assistance Agreement". There is no legal requirement that these companion elements of the arrangement, the "know-how" and "show-how" as they are sometimes labelled, be dealt with in separate contracts. Such separation is the general rule, however, where technical assistance is a significant factor.

Terms of Agreement

The technical assistance agreement should define with great precision the nature and extent, times and places of the assistance to be provided. The process may involve sequential or overlapping

phases including visits by members of the licensee's staff to the licensor's plant for onsite training, reciprocal visits by the licensor's personnel to the licensee's plant, transfer of such personnel to the licensee's staff for a sustained period and services performed by the licensor independently in his own facility for the benefit of the licensee.

Payment Terms

Since technical assistance is usually in aid of a licensing or joint venture arrangement, the approach to remuneration is often one of reimbursing expenses rather than attempting to realize a profit. Thus, a typical payment provision would be one requiring the licensee to reimburse the licensor for all costs wholly attributable to assigned personnel at specified per diem rates plus travelling and living expenses. If the licensee requires technical assistance only for limited purposes during a startup period, he may take the position that such assistance is entirely supplemental to the basic transfer of technology under the license and ought to be provided at the licensor's expense. Frequently, the agreement creates a rather open-ended framework within which the licensee may call upon the licensor for assistance according to his needs but conditional upon the licensor's ability or willingness to provide.

Immigration Requirements

An extraneous matter to the technical services agreement, but one which must not be overlooked, is the necessity to obtain Canadian visas for foreign workers. Situations may arise in which representatives of a technology supplier may visit Canada for such a limited purpose and duration that only visitor's status is appropriate. A non-Canadian intending to work in Canada must seek either a temporary employment authorization or permanent resident status, depending on the circumstances of his assignment. It is advisable to seek advice from the Canadian immigration service or legal counsel as to the type of authorization required and appropriate procedures.

Except for special categories of persons who

are exempted, including key executives transferring within a related corporate group, confirmation from a Canada Employment Centre within Canada that the position cannot be satisfactorily filled from the Canadian domestic work force is the first step. This confirmation may then support an application to the Canadian Immigration Service abroad for the appropriate visa. The confirmation of an offer of employment is issued to the corporation or other business entity seeking to employ a foreign worker whereas the employment authorization itself is issued by the Canadian Immigration Service, outside of Canada, to the worker himself. Special provisions in the Canada-United States Free Trade Agreement preclude the necessity to obtain a confirmation of offer of employment in many situations involving transfers of technicians, professionals or management personnel between the signatory countries.

Each of the provincial governments has a department that will advise commercial enterprises with regard to problems of international personnel transfers. In Ontario, this is the Business Immigration Section of the Ministry of Industry, Trade and Technology.

Once an employment authorization is obtained, it can be renewed within Canada on a yearly (or shorter) basis so long as the extension is justified by the original purpose up to some maximum period of temporary residence. Temporary employment authorizations issued to a married person do not entitle his spouse or children to work in Canada unless they qualify for such authorization in their own right. This is a significant difference from permanent resident status, which applies to the spouse and never married children of any age, which confers the right to accept employment on all family members.

In practice, permanent resident status is obtained through a process similar to that for temporary work authorization but somewhat more rigorous and normally requiring a substantially longer period for processing. It is not appropriate unless the transferring party is being assigned to Canada for an indefinite period.

TAX FACTORS AFFECTING TRANSFERS TO CANADA

TAX FACTORS AFFECTING TRANSFERS OF TECHNOLOGY TO CANADA FROM ABROAD

In this section, we summarize the Canadian taxing provisions which most often apply to technology transfers from abroad by way of licensing and technical assistance arrangements. Tax laws in the country of transfer will also come into play and may have a bearing on the transferor's preferences as to how the arrangement should be structured. For instance, he may have an opportunity to characterize the consideration which he receives as a capital gain instead of an income receipt. This characterization would probably suit his interest because capital gains are usually taxed at a lower rate than ordinary income. The Canadian transferee, on the other hand, will obtain a larger tax deduction if his payments are characterized as payments on income rather than capital account.

Licensee's Tax Position

A Canadian licensee will wish to deduct the consideration paid for license rights and technical assistance to the maximum extent possible for tax purposes. The deductibility of such amounts is not usually in question provided they are reasonable. They are ordinarily characterized as royalties or payments for services, and in either event are fully deductible.

There may be circumstances in which deductibility is more limited. Particularly where lump sum payments are involved, the licensee should seek professional advice with regard to tax treatment. While in special circumstances even lump sum payments for the transfer of technology may be treated as royalties paid on income account, they are more likely to be characterized as capital expenditures. As such, they are depreciable on a "straight-line" basis over the life of the license. Details on this subject may be found in Revenue Canada Interpretation Bulletin No. IT-477 which is reproduced in Appendix III-B.

Licensor's Tax Position

Technology transfers should be scrutinized carefully to ensure that no amount paid by the

transferee is unnecessarily or inadvertently subjected to Canadian withholding tax. Royalties paid or credited by a Canadian resident to a non-resident are subject to Canadian withholding tax. This tax is imposed at a rate of 25% under the Income Tax Act, but this rate is reduced to 10% or 15% for payments to persons resident in those countries with which Canada has entered into tax treaties. In Ontario, an amount equal to five-fifteenths of the royalty payment must be included in computing the licensee's income for provincial tax purposes where the licensee and licensor do not deal with each other at arm's length. Because of their great importance to the subject matter of this book, the relevant provisions from the Income Tax Act, Revenue Canada Interpretation bulletin No. IT-303 and applicable excerpts from several of Canada's tax treaties are set out in Appendix III-C.

TECHNICAL SERVICES RENDERED IN CANADA

The rendering of technical services in Canada by the employees of a foreign licensor is likely to constitute "carrying on business in Canada" within the meaning of the Income Tax Act. While under the Act the profits of such businesses are taxable in Canada at full corporate rates, the Income Tax Act is subject to the provisions of Canada's income tax treaties with other countries. Such treaties invariably provide that the commercial and industrial profits realized by a resident of the other country are taxable by Canada only if the non-resident maintains a "permanent establishment" in Canada. Most foreign licensors from treaty countries will wish to avail themselves of treaty protection by taking appropriate precautions to ensure that the activities of their employees or agents in Canada do not create a "permanent establishment".

While full discussion of the term "permanent establishment" is beyond the scope of this book, we suggest that foreign companies rendering technical assistance in Canada and not desiring to create a "permanent establishment" generally observe operating procedures such as the following:

1. They do not establish their own office, laboratory or plant facilities, but rather utilize the facilities of the licensee.
2. They do not enter telephone or other business listings and have no door plaques or business cards identifying themselves as a place of business in Canada; the use of telephone answering services is not out of the question but is rarely required.
3. The employees and agents of the licensor are not given general authority to contract for the licensor and do not purport to exercise any such authority.

These procedures may vary depending upon the definition of "permanent establishment" found in the particular tax treaty which Canada has negotiated with the country in which the licensor is resident. In those cases where no tax treaty exists, virtually any business activity of the licensor's employees or agents in Canada will be found to constitute carrying on business, with the result that any resulting profits will be taxable in Canada.

Although the licensor rendering technical assistance may not be required to submit to Canadian taxation, when they are not employed by a Canadian resident, Canadian residents who make payments to such non-residents for services rendered in Canada are required to withhold and remit 15% of such payments to the Receiver General of Canada. Relevant sections of the Income Tax Act and Regulations are set out in Appendix III-D.

At the end of each year, the licensor must file a tax return, establish to the satisfaction of Revenue Canada that it is entitled to the benefit of a tax treaty and claim a refund of the amount withheld. Licensors should be made aware that one of the grounds for obtaining such a refund is that the payments from which amounts were withheld represent industrial and commercial profits and not royalties, i.e., payments for technical services and not for the use of intellectual property. This is one of the reasons for preparing technical assistance agreements and devoting attention to the characterization of the services being rendered as separate from the transfer of technology provided for in the license agreement.

SERVICES RENDERED BY THE LICENSOR IN ITS OWN COUNTRY

It is not uncommon for a transferor of technology to render some services to the transferee in the transferor's home country, for which a separate

service charge may be levied. Such services will not constitute carrying on business in Canada, and payments for such services will not be taxed on that basis. If the services are managerial or administrative in nature, the payments may attract Canadian withholding tax as discussed under the next heading. Withholding tax is also levied on payments by a resident of Canada to a non-resident in connection with services of an industrial, commercial or scientific nature without reference to the situs of such services, where payment is based in whole or in part on:

- (a) the use to be made of the services or the benefit to be derived from same; or
- (b) the production or sales of goods and services; or
- (c) profits.

Payments for the transferor's services ordinarily do not come within one of these categories.

MANAGEMENT OR ADMINISTRATION FEES

Management and administration fees paid or credited by a Canadian resident to a non-resident are subject to a withholding tax equivalent to the withholding tax on royalties. It is our experience that the services rendered in assistance of technology transfers between unrelated parties are not usually of a management or administrative nature. However, for cases in which such services are provided, it is important to know that the withholding tax is not dependent on the situs of the services but applies whether or not the services are performed in Canada. Under an exempting provision, a payment for services that include management or administration will not be subject to withholding tax in Canada if either:

- (a) the services performed by the non-resident were performed in the course of a business carried by him that included the performance of such services for a fee and the parties were dealing at arm's length; or
- (b) the payment was made to reimburse the non-resident for reasonable expenses incurred on behalf of the Canadian residents.

As in the case of royalty payments, five-fifteenths of the amount of the management or administration fee will be included in computing the licensee's income for Ontario tax purposes where the licensee and licensor are not dealing with each other at arm's length. (See Appendix III-F - Revenue Canada IT-468).

JOINT VENTURES

"AN ORGANIZATIONAL FORM WHOSE TIME HAS COME"

There is a large and rapidly increasing body of writing on the subject of joint ventures. A recurring theme is that joint venture enterprise has grown rapidly since World War II and promises to grow even more rapidly in the future. It is said to be "an organizational form whose time has come" and is predicted to become an "increasingly prominent feature on the corporate landscape".* At the same time, the writers of books and articles explore the special requirements for joint venture success. These include: careful partner selection to ensure a "good fit", thorough planning and documentation, willingness to accept cultural differences, practical working arrangements with regard to control and maintenance of mutual trust.

REASONS FOR JOINT VENTURE ENTERPRISE

As previously noted, joint ventures are formed for a variety of reasons. In his book, *Strategies for Joint Venture Success*,* Peter Killing lists four reasons which will serve to focus attention on underlying motives. Of these, the last two are likely to be especially applicable to the small and medium-sized businesses to whom this book is directed. The four reasons are as follows:

- "1. Government insistence.
2. The project is too large, financially, for either party to handle alone.
3. Neither firm has all of the skills, typically technical and marketing, to make a success of the business on its own.
4. Only by combining forces can the joint venture partners achieve satisfactory economies of scale in research and development, production or marketing."*

* *Strategies for Joint Venture Success*, J. Peter Killing, Croom Helm Ltd., 1983.

POSSIBLE IMPACT OF FOREIGN LAW

United States and European Economic Community anti-trust laws may have an impact on joint ventures with parties based in those jurisdictions (refer also to page 47). Primary responsibility for compliance with such laws will fall upon those parties. Canadian participants should be aware of their existence, however, and be guided by specialized counsel in the foreign jurisdiction.

MEANING OF "JOINT VENTURE"

There is no precise meaning for the term "joint venture". In the broadest sense, any arrangement in which two or more businesses combine resources for some definable undertaking is a joint venture. The Canadian legal system provides great flexibility, and imposes very few restrictions as to the form which joint ventures may take.

"NON-EQUITY" JOINT VENTURES

A wide variety of co-operative arrangements including licensing, technical assistance agreements, contract manufacturing and even sales agency and distributorship arrangements are sometimes loosely categorized as "non-equity" joint ventures. The term suggests at the least some vital contribution from each party and a degree of continuing active involvement.

"EQUITY" JOINT VENTURES

It is more common to speak of "equity" joint ventures in which each party has a proprietary interest and a direct share of risk. This kind of business organization may itself take a variety of forms, but these may be segregated broadly into two categories, the incorporated joint venture and the unincorporated joint venture.

MEETING THE TEST OF NET BENEFIT TO CANADA

Some joint ventures require approval of the Government of Canada under the Investment Canada Act, which is discussed in more detail on page 72. Such approval is based on finding that the venture is likely to be of net benefit to Canada taking into account the criteria of benefit specified in the Act. It is in the nature of most joint ventures to meet a number of these criteria for benefit such as Canadian participation and positive impact on "productivity, industrial efficiency, technological development, product innovation and product variety in Canada". Most joint venture proposals will readily pass the test of net benefit. In certain key industries, joint ventures with Canadian partners may prove to be the most satisfactory means of entry for the foreign investor.

COMPLEX NATURE OF THE JOINT VENTURE IMPLEMENTATION

It is a more complex exercise to work out the parameters of a joint venture and integrate its many details into a comprehensive set of documents than it is to settle the terms of a single license or technical assistance agreement. We emphasize that properly implemented technology transfers are the product of interaction among the business principals and skilled professional advisors. No technology transfer is a do-it-yourself project. Our checklist appears in Appendix III-E.

PRELIMINARY DOCUMENTATION

As negotiations move past the exploratory phase, non-binding memoranda or terms of agreement and exchanges of proposed language can assist the parties to make progress toward agreement. To an even greater degree than in licensing, so-called "standard" agreements should be taken only as points of departure. In some instances, a preliminary agreement is concluded to perform a feasibility study of the proposed project on the understanding that if specified results are obtained, a definitive joint venture agreement will be negotiated.

DESIGNING THE JOINT VENTURE AGREEMENT

The elements of drafting discussed in connection with license agreements apply equally to joint venture agreements. Clarity and absence of ambiguity are critical. Defined terms and schedules may be used to good effect. A joint venture agreement usually utilizes a series of recitals to describe the parties, with reference to the experience or expertise which each brings to the venture, possibly their past dealings or the circumstances which have led to their joining forces and possibly the purpose of the venture. The latter is more likely to be touched upon in the recitals and comprehensively described in one of the early operative clauses.

Since joint ventures by their nature involve some relatively limited or well-defined business activity, it is important that purpose and scope be defined with some precision. Naturally these may change with the passage of time and events, but changes in basic intentions should, in turn, be documented to avoid misunderstandings.

Designing the scope and purpose provision may prove to be more demanding than anticipated. The attempt alone may have the effect of exposing unsuspected differences in perspective and act to prevent later discord.

The Dominant Issue: Control

The predominant issue in forming and operating an equity joint venture, whatever its form, is likely to be the issue of control. Since each party is heavily committed to the venture in terms of capital, expertise, expectation of profit and risk, an attempt is usually made to work out some form of shared control. The joint venture contributor of key technology is likely to have a lively interest in the supervision of its use and further development. Indeed, the ability to participate in control probably accounts largely for his choosing joint venture operations instead of granting a license. The party who would otherwise be in the position of a licensee probably has practical operating experience and may be the major contributor of plant and equipment as well as market knowledge and significant elements of the venture's technology base. It is obvious that he will seek to play a significant if not predominant role in control.

Shared control is not the only option, as one might be inclined initially to believe. There are joint ventures in which one party is given control either absolutely or, more likely, under the overall

direction of some joint body which restricts itself to long-term strategy. There are others in which the parties agree to delegate a large measure of control to the general manager and maintain a "hands off" policy in relation to day-to-day affairs. Studies indicate that, statistically, such "dominant parent" and "independent" ventures have a lower failure rate than those where control is shared. They appear to be well suited to ventures with a short time frame where decisive management is critical to success.

If one party is primarily a passive investor and the other an "operator", wisdom may dictate that operational control should rest in the latter. Where equity participation is unequal, the larger equity owner(s) may demand a predominant voice in control and management. Nevertheless, shared control is the norm, and the mechanisms for exercising shared control are a central feature of the agreements and other constituent elements of most joint ventures. The joint venture party located in the host country should not underestimate the significance of its contributions as issues of equity participation and control are negotiated.

The issue of control arises at different levels. Difficulties more frequently arise in relation to short-term policy decisions and day-to-day operations than in relation to general policy.

Although our principal focus is on corporate organization and contractual terms, it is well to note that control may be influenced by a variety of other factors. A distinction should be made between the "negative control" which characterizes the defensive mechanisms embodied in formal agreements and "positive control", which encompasses all the techniques of leadership.

OTHER CONSIDERATIONS: ANCILLARY AGREEMENTS: LICENSING

Among the many other important matters to be considered by parties contemplating a joint venture are the definition of their respective contributions of time, money, technology and tangible assets, future funding, the mechanisms by which each will be compensated, record keeping and access to records, duration and rights of termination. These considerations provide subject matter for the basic joint venture agreement. They also give rise to a variety of ancillary agreements covering such matters as management services, licensing, technical services, financing, manufacturing, sources of supply and marketing.

Of all these, the licensing agreement is likely to be the most important since the transfer of technology may be at the very foundation of the venture. License arrangements in the context of joint ventures are not unlike arm's-length license agreements. A good rule of thumb is to give as much attention to the transfer of technology to the joint venture as would be given if the parties were not otherwise associated. Indeed, the interests of the parties may in many respects be the same as they would be in an arm's-length licensing arrangement. The main difference is the leverage in terms of control which the license gives to the technology transferor. The other party may perceive it to be his duty to assume the role of defender of the joint venture in negotiating the license agreement.

The parties sometimes attempt to entrench the principle of fair and objective dealing as between either of them and the venture by providing in the joint venture agreement that all such dealings must be on an arm's-length basis.

The material which follows assumes for the most part a two-party joint venture with essentially equal equity participation. This viewpoint is adopted from convenience and because it represents the majority of actual joint ventures in the field of manufacturing. We believe that most of the principles discussed may be applied to multiple-party and unequal-equity ventures.

Incorporated and Unincorporated (Contractual) Equity Joint Ventures

The incorporated joint venture is one in which each party becomes a shareholder in a corporation formed specifically to conduct the business of the joint venture enterprises. Implementation usually begins with the preparation of a pre-incorporation or shareholders' agreement which sets out general intentions, a specific program for moving into the corporate structure and some contractual provisions which govern the relationship of the parties to the venture throughout its existence. Once the joint venture corporation has been organized and given its own life, the relationship of the parties is governed not only by their original contract but by the corporation's articles of incorporation and by-laws and the entire body of statutory and non-statutory corporation law.

The unincorporated or contractual joint venture is one in which each participant retains its own corporate identity. The relationship as co-venturers is defined entirely by contract, which may account for the fact that purists tend to regard this form as the "true" joint venture.

PREFERENCE FOR INCORPORATED JOINT VENTURES IN MANUFACTURING

The business person is not concerned with purity of form but with finding the most appropriate vehicle for carrying out his or her business purpose. We have found that incorporation usually proves most suitable for a manufacturing venture. The vast majority of manufacturing joint ventures with which we have been associated, or of which we are aware, are incorporated.

This preference appears to be based on both business and legal factors. A manufacturing venture is not usually a short term or highly restricted undertaking. The corporation has an indefinite life and creates a familiar framework for financing and administration of an ongoing business enterprise. The notion of "corporate image" as a means of identifying the business and its products to suppliers, financing institutions and consumers alike, emerges as a significant psychological factor. A corporation is a convenient vehicle for the creation and exploitation of goodwill in the broadest sense and for the exploitation and protection of trademarks, for instance, in a narrow legal sense. The basic legal consequence of incorporation is limited liability, that is, in the absence of contractual guarantees the shareholders are not individually responsible for the corporation's obligations.

STRUCTURAL AND LEGAL CONSIDERATIONS FOR THE INCORPORATED FORMAT

It may well be asked why parties who are free to create a joint venture and govern their relationship by a simple contractual arrangement should impose upon themselves the vast array of legal and administrative complexities which are inherent in the corporate form of organization. As shareholders, their dealings with third parties are not direct in the legal sense but are exercised through the "organs" of the corporation, namely, its officers and directors. Neither party has the right, as such, to enter into contracts for the venture but may only do so as authorized by resolution of the board or other appropriate proceedings of the corporation. To some this may be a natural and orderly way to run a business; to others it may seem unnecessarily cumbersome.

In an incorporated joint venture, property of the venture is property of the corporation and

consequently one-removed from direct ownership. Equity is represented by shareholdings. Expenses of the venture are the expenses of the corporation and not its shareholders, an elementary fact with important tax consequences. Finally, the involuntary termination of a corporate joint venture may be more complicated than termination of the contractual relationship.

Most apparent drawbacks of incorporation can be overcome or accommodated. The modern corporation is in many respects an admirably streamlined and flexible vehicle for any business enterprise, including joint ventures. The indirect holding of equity through shares and the necessity of acting through organs of the corporation, which make for a degree of complexity, also give the corporation its unique flexibility.

Because of its importance, our main focus in the following pages is on the design and structure of incorporated joint ventures. Many of the principles discussed are equally applicable, however, to ventures of the unincorporated variety. Let us first take a closer look at the uses of unincorporated joint ventures.

USES OF UNINCORPORATED OR CONTRACTUAL JOINT VENTURES

In Canada, unincorporated or contractual joint ventures are most common in the energy and natural resource sectors. They are also used for many construction and engineering projects. Typically, a Canadian corporation bidding for participation in a project which requires a combination of technologies will engage the assistance of one or more suppliers of foreign technology to contribute its knowledge and expertise on a temporary, unincorporated basis. While there is no legal limitation on use of unincorporated joint ventures in manufacturing, they are less common in that context for the reasons previously noted.

It would appear generally that the more limited the contemplated venture in scope and duration, the more likely it is that the parties will favor the unincorporated format. Such projects tend to generate a preference for maintenance by the parties of their separate identities within the venture. This factor is significant where it appears desirable for one of the parties to assume general management or the primary interface with third parties. A practical result of maintaining separate identities is that the parties may be able individually to deduct their respective shares of the

expenses of the venture for tax purposes.

Many unincorporated joint venture projects involve one or more exploration or experimental phases and possibly, depending on outcome, a more permanent phase. For the long-term or permanent phase the parties may turn to the incorporated format.

Unincorporated joint ventures have the advantage that they may be meticulously tailored to the particular need. The relationship is fully defined by contract, obviating the complexities of corporate structure discussed earlier. This is not to say that it is a simpler task to design and document an unincorporated joint venture than the corporate form. To the contrary, the agreement governing an unincorporated joint venture is likely to be more comprehensive because it must provide within its own framework for matters which are dealt with in articles of incorporation and by-laws in the case of a corporation. We have found that in many instances greater importance is attached to the definition of the scope and limitations of the venture, accounting procedures and management provisions.

UNANIMOUS SHAREHOLDER AGREEMENT

Modern corporations' statutes such as the Ontario and Federal Business Corporations Acts provide a device known as the unanimous shareholder agreement which can be used to reduce the structural complexity of a corporation for joint venture purposes, while retaining its many attractive elements.

There has always been some doubt in Canada about the degree to which courts would enforce the promises made by joint venturers in shareholder agreements apart from obligations flowing from their status as shareholders. Under the common law of corporations, the discretion of directors cannot in any way be fettered. This translates into the proposition that one shareholder cannot contract with another that his nominee directors will necessarily vote in a predetermined manner.

This rule has created a dilemma for lawyers attempting to create corporate joint ventures in which the will of the shareholders, as expressed in their agreements, will always shape decisions of the board. There may even be some doubt under general corporation law as to the effectiveness of an agreement to vote shares in a particular manner. Issues of this nature have been the subject of extensive litigation in the United States. They can

now largely be resolved by the use of unanimous shareholder agreements.

The effect of a unanimous shareholder agreement is to restrict the powers which the directors would otherwise have to manage or supervise the management of the joint venture business to any extent which the agreement provides. The agreement may, among other things, provide its own mechanisms for amendment and arbitration of disputes. Indeed, the shareholders may preempt the functions of the board of directors altogether if they so choose and thereby assume direct responsibility for management. This may merely reveal the need for a management body comparable to a board of directors, leading to a decision to leave the board intact but with its powers circumscribed by the agreement.

There are no special legal requirements for the formation of a unanimous shareholder agreement except that it must be a written agreement among all the shareholders of the joint venture corporation. Persons who are not shareholders may also be parties. It must be remembered that the benefits of a unanimous shareholders' agreement flow by operation of law from the statute under which the joint venture corporation is formed. Parties to a proposed joint venture should review such enabling statute.

The flexibility of the unanimous shareholders agreement brings with it a need for extreme care in designing and drafting the agreement and supporting documents because shareholders assume the liabilities as well as the powers taken from directors. These range from filing requirements to liability for unpaid wages. For this and other reasons some joint venturers may find the traditional delegation of substantial powers to a managing board of directors to be in their best interest.

INCORPORATION

Formation of a corporation for the purpose of the joint venture enterprise may precede the signing of a shareholders' agreement, which will then make reference to its name, capital structure and other characteristics. Alternatively, the joint venture agreement may take the form of a pre-incorporation agreement which spells out as part of the understanding that a corporation is to be formed with specified characteristics. Information on

filing of a corporation is available from:

Corporate Services Section
Companies Branch
Ministry of Consumer and
Commercial Relations
Tel: (416) 593-8880

Some key points are set out below:

- The corporate name must not be confused with the name of an existing business. A computer printout evidencing an availability search for the proposed name must accompany the Articles of Incorporation.
- The corporation may do business under one or more trade or divisional names by registering such names. In Ontario, such registration is effected under The Corporations Information Act.

Most Canadian corporations' statutes require that some proportion of the board of directors be "resident Canadians", a term usually defined to include immigrants from other countries during the period of three years that they must be resident in Canada to qualify for citizenship plus an additional year (for a total of four years from the date of landing), to allow for Canadian citizenship to be obtained. Foreign joint venture partners should be alerted early to the fact that one or more of their representatives on the board of the incorporated joint venture must meet this qualification. The Provinces of Quebec and New Brunswick have no such requirements. No Canadian corporations statute has a citizenship requirement for corporate officers.

If the joint venture is subject to approval under the Foreign Investment Review Act, undertakings with regard to Canadian participation may be given to support the proposition that the venture is likely to be of significant benefit to Canada and may deal with the citizenship of officers.

Corporations formed under the Ontario and Federal Business Corporation Acts have all the powers of a natural person and consequently require no objects clauses in their Articles of Incorporation. Current practice is to define the purpose and scope of the joint venture by agreement and not include objects clauses in the Articles.

Authorized capital provisions may be as simple or as sophisticated as required. In the simplest case, the corporation may issue an unlimited number of shares of any designated class. All shares are without nominal or par value. There is no requirement for a minimum paid-in capital, although the tax implications of "thin capitalization" should be noted.

All issued shares must be registered. Shares are not validly issued unless fully paid for in money, property or past services. The joint venture agreement should contain details of initial capitalization in terms of the numbers and classes of shares to be issued and the nature of the consideration to be paid for them. The requirement of the corporation law that all issued shares be fully paid for and related provisions mean that the parties must agree in advance on the money value of all technology and other intellectual property, all tangible property and services for which shares are issued.

The Articles of Incorporation of a closely-held corporation contain provisions referred to as "private company clauses" to help eliminate certain filing requirements pursuant to securities legislation. These clauses usually include a restriction on the transfer of shares without the consent of the shareholders or directors. Such clauses must be co-ordinated with provisions in the joint venture agreement regarding the transfer of interests.

The corporate businesses of both shareholders and directors may be transacted in meetings or by the signing of consent resolutions. This makes it convenient for shareholders at a considerable distance from each other to transact and formally document their corporate business.

BOARD OF DIRECTORS

While shareholders may give written proxies to others to vote their shares, directors must act personally. Canadian law does not provide for the election of alternate directors.

Shareholder agreements usually provide that all shares will be voted so as to ensure each party's agreed representation on the board of directors. There are a variety of devices by which such equality can be assured. This question will have lesser importance to the degree that the shareholders themselves assume powers of the board by a unanimous shareholder agreement. However, the powers of the board of directors are eliminated altogether, and because of its powers to manage the affairs of the corporation, care must be taken in organizing its structure and operations.

In the common two-partner, equal-equity venture, the director provisions usually contemplate a board of even numbers on which each party has equal representation. Such an arrangement has the effect of giving each a veto over policy decisions affecting the venture. The

same effect is obtained in multiple-party joint ventures by providing in the agreement and again in the corporation's by-laws that all resolutions of the board, or those dealing with specifically designated matters, are to be decided by a special majority or unanimous vote of all board members. Such provisions are examples of devices for exercising what may be called "negative control".

Once elected, directors have the powers to manage the affairs of the business which the joint venture participants choose to leave with them. Quorum requirements can ensure that the representatives of each participant are present at board meetings and approve of proposed actions. Canadian law allows great flexibility in establishing quorum and voting requirements.

OFFICERS

Whatever the risks of conflict, it is very common for both joint venture parties to be represented at the level of day-to-day management. The reasons for this are obvious. Where technologies are being joined, there is probably a practical need for continuous operating liaison. In addition, each senses a need to protect its vital interests.

Corporate officers are usually drawn from the ranks of the parent corporation, sometimes leading to competition to ensure equal representation. We have seen joint venture agreements in which each second officer in a long pecking order was to be a designated representative of one party and the remainder designated by the other. A similar approach is to divide officers by position into roughly equal groupings, with one party nominating or supplying the incumbents of one group of positions. It has even been suggested that the right to nominate for each group of positions might be rotated annually.

Such formulas appear logical but prove unsatisfactory. There is no ideal solution. Common sense in relation to the specific needs of the venture, the persons most capable of performing various functions and the legitimate interests of each party are the essential ingredients. Some venturers have found merit in the selection of a general manager unrelated to either of them, if not at start-up, then after the venture has reached a stable phase. We noted earlier that studies indicated a higher statistical likelihood of success where some measure of independent management is present.

CAPITALIZATION OF THE JOINT VENTURE CORPORATION

Initial capital must be paid into a corporation to complete its organization. Each joint venturer subscribes for its proportionate amount of the share capital for cash consideration or for property or services to which a specific monetary value is attributed by board resolution or provisions of the unanimous shareholder agreement. The necessity of valuing the non-cash consideration is dictated by both corporate law and tax considerations. A simple and painless way to establish the basic equity relationship of the venturers is to cause the newly-incorporated corporation to issue its common shares in the appropriate proportion for a relatively nominal consideration before substantial amounts of property have been acquired or contributed. Additional capital may then be raised by way of loans or the issuance of special shares to the co-venturers or third parties.

Joint venture participants may structure their investment in virtually any way they wish, by creating shares in the capital stock of the corporation with a wide variety of rights and conditions, including some or all of the following:

- voting rights, either generally or on specific matters;
- fixed, discretionary or preferential dividends; redemption and retraction rights at redemption amounts either fixed in advance or as fixed at the time of redemption or retraction;
- rights to participate in the assets of the corporation upon its dissolution; and
- the right to elect a certain number of directors.

A useful device for allocating rights among parties to a joint venture is the issuance of shares of different classes or of different series within the same class.

Similar flexibility may be enjoyed through the use of debt instruments. Shareholder loans may be documented by simple promissory notes bearing fixed interest rates or more complex agreements containing repayment provisions based upon earnings or performance. Debt securities can be designed to be convertible into equity at the option of the lender or the corporation.

EXISTING CORPORATIONS

Many joint venture corporations result not from the creation of new corporations but from the investment by a new participant in an existing

corporation. The existing corporate structure and obligations are additional factors to be considered in planning the structure and operation of the corporation as a joint venture. Canadian law provides for virtually unlimited flexibility in amending articles of incorporation and corporate by-laws.

TRANSFER OF TECHNOLOGY

There are several ways in which a transfer of technology from a joint venture participant to the joint venture can be implemented. It may be transferred outright in exchange for shares or debt of the joint venture company. Most often, the transferring joint venture partner will opt to transfer his technology pursuant to a license agreement. Licensing usually proves to be the most effective way of safeguarding his technology, even against the corporation in which he is a participant. Licensing arrangements within joint ventures were discussed on page 60.

The combination of a licensing arrangement with a joint venture raises the question whether, and to what extent, the technology supplier is to be allowed to take money out of the venture other than by way of a distribution of after-tax profits by way of dividends. He may argue that his equity position in the venture should be treated quite separately from his license of technology and that the latter should carry the same royalty which would be charged to unrelated parties. Even if this proposition is accepted, the other party should ensure that the technology supplier makes a full capital contribution.

The difficulty is that initial capitalization may be modest, with the real prospects of the business depending on the intangible inputs of each party. In such case it may be possible to make a strong argument that the initial disclosure of technology should be an outright transfer for a determined value with no additional royalty charge. An alternative argument is that the royalty, whether for present or future technology, should be at a lesser than arm's-length rate, although the transferor may have difficulty justifying such lesser rate for tax purposes in his own country.

FURTHER CAPITAL REQUIREMENTS

Participants in a joint venture should establish at the outset a set of plans and policies for future

funding. Although initial contributions and available institutional financing may provide for foreseeable needs, the possibility is always present that additional direct equity contributions may be required. The ratio in which they may agree to participate in future funding is a matter of negotiation. A question requiring equal deliberation and clear expression in the joint venture agreement is what consequences will follow from the failure of one party to make a contribution when required to do so. The following are some approaches to this problem:

1. The unpaid amount may become a charge on future profit distributions to the defaulting party.
2. The unpaid amount may be advanced by the other party at his option and treated as a payment on behalf of the defaulting party, whereupon it is secured by a charge on the latter's profit distributions or equity in the venture.
3. Following a lapse of time to allow full opportunity for performance, the defaulting party may be required to dilute or forfeit his interest in the venture or sell the same to the non-defaulting party or the venture at a predetermined bargain price.

DISTRIBUTION OF EARNINGS

Prospective joint ventures tend to focus their attention at the outset on organizational matters and start-up activities. It should not be forgotten that the purpose of the venture is the realization of profit and that differences may arise regarding the distribution of earnings. Each participant may have a different position in the inevitable tension between immediate distribution, with its obvious attractions, and retention of earnings for reinvestment and sustained growth. In a corporate joint venture, the matter may be left to the discretion of directors, where it normally resides under Canadian law. Alternatively, the parties may establish a minimum distribution policy as part of the joint venture agreement.

If the venture provides for "negative" control by each party, with its built-in potential for deadlock, the result of failure to establish a minimum distribution policy in the joint venture agreement may be the absence of distributions until the problem is resolved. Joint venture agreements often provide for the current distribution of some proportion of earnings or of all earnings subject to a reserve for capital growth. It may be further

agreed that the level of earnings distributed will vary according to predetermined standards of performance.

TERMINATION

A limited-term joint venture may run its course and terminate according to its terms. Any joint venture may be terminated amicably or go through a substitution of parties upon a decision by one or both parties to change business direction. The most common example is the negotiated purchase by one party of the other's shares. Finally, termination may result from a disagreement between the parties.

SUBSTITUTING A PARTY

A participant in a joint venture is rarely indifferent to the identity of the other party or parties. The obvious reason is that the venture is founded upon the identification by each of suitable co-venturers, an assessment by each of the other's contribution and some measure of trust and compatibility. The question of party substitution may well be a question of venture survival. At the least it will evoke concerns about the protection of intellectual property and general maintenance of confidentiality.

The question of party substitution usually arises when one participant seeks, for whatever reason, to transfer its interest to a third party. An aspect of the issue sometimes overlooked is the potential for indirect partner substitution by way of change of control in one of the parties. Such changes are difficult to control at the joint venture level. However, various devices are available including automatic termination or forced buyout of the equity of the party undergoing a change of control at the option of the other party.

RESTRICTIONS ON TRANSFER OF SHARES

Ontario and federal corporate law do not require any restriction on the transfer of shares, but it is common to include a provision requiring director's approval for such transfers. In our experience, joint ventures invariably restrict the transfer of one party's shares without consent of the other.

Persons acquiring shares which are subject to a unanimous shareholder agreement are deemed to be parties to the agreement. The agreement will

usually provide for share certificates to bear a legend stating that they are subject to its provisions.

DEADLOCK

The consequence of effective "negative" control is the development of a deadlock in the event of conflict. Some students of joint ventures have pointed out that the potential for deadlock may be seen as positive on the basis that risk of deadlock and consequent paralysis of the venture may operate as an incentive to amicable solutions. It is also argued that provisions for breaking deadlock situations may have the effect of a self-fulfilling prophecy, inducing the possibility or frequency of deadlock votes. The counterargument is that because of the serious potential consequences of disagreement, it is important to choose a mechanism for breaking deadlock situations.

Such mechanisms may operate at different levels. For instance, the corporation's by-laws may provide for one director to have a casting vote. To make such a provision as fair as possible, the power to exercise such vote may be passed between nominees of the parties on a rotating basis or vested in a "neutral" board member. More drastic mechanisms for dealing with resolving deadlock situations are those which result in a buyout of one participant by another, introduction of a new party or winding up.

RIGHT OF FIRST REFUSAL

Most business people are familiar with the term "right of first refusal". There are two basic approaches to granting such rights. One is to require the participant wishing to sell to give the other the right to match third-party offers. This is often thought to be a drawback of the right of refusal device because third parties may be reluctant to make offers subject to a prior right of refusal. This may not be a deficiency in the joint venture context, however, where it is rarely in the participants' interest to facilitate sales to third parties. Another difficulty of the first right of refusal lies in establishing the bona fides of the third-party offer.

The second approach is to provide a formula for determination of the buyout price. It is then provided that one participant may offer his interest in the venture to the other at the predetermined price and on such other terms as the agreement provides. If this offer to sell is not accepted, the

offering party is free for some period to sell to a third party on the same basis. Establishing a formula for fixing the buyout price may present difficulty. Some alternatives are book value, capitalized earnings, appraised value or some variation of these. Another choice is to leave valuation to an independent third party.

For some reason, right of first refusal clauses are among those most often found to be badly drafted. The idea seems to be prevalent that brief mention of the concept itself is sufficient to create all necessary rights and obligations. This is not the case. The specific intentions of the parties must be spelled out in detail. It is particularly important to identify the extent, or limitations, of the rights and to provide appropriate mechanisms for administration.

JOINT VENTURE CORPORATION PURCHASE OF ITS OWN SHARES

Either of the devices referred to in the preceding paragraph may be structured in such a way that the joint venture corporation itself is the purchaser. This arrangement is a convenient way to maintain proportionate joint venture interests for the remaining parties in a multiple-party venture.

THE BUY-SELL CLAUSE

The put-sell or buy-sell arrangement is a traditional device for orderly disengagement. Under this procedure, one party gives notice of a desire to buy or sell his interest in the joint venture and proposes a price per share for such a transaction. The party receiving such an offer must then agree to purchase the shares of the offeror or sell its own shares at the same price. Buy-sell provisions are usually very detailed, providing for terms of payment, mechanics of share transfer, settlement of obligations between the selling shareholder and the corporation and other details.

Buy-sell provisions are so common that there is a tendency to introduce them without sufficient forethought. They work fairly if the parties are equal in their proportionate interests in the venture, financial capability and legal status. In the event of significant inequality in any of these areas, the weaker party may be severely disadvantaged. If the weakness is financial, the bidding partner may propose an unreasonably low price knowing that the other is more likely to sell than to buy. If the foreign party may only purchase subject to Government approval, he is obviously at a disadvantage.

ARBITRATION

Arbitration is often more attractive to international joint venturers than resort to the courts of either jurisdiction. It may be structured on an ad hoc basis, as where each party chooses an arbitrator and the two so chosen a third or reliance may be placed in an arbitral institution such as the International Chamber of Commerce (ICC), the Institute of Arbitrators (London), the American Arbitration Association, the International Center for the Settlement of Investment Disputes (ICSID) and the Inter-American Commercial Arbitration Commission.

If the ad hoc approach is selected, reference to one of the more widely accepted set of arbitration rules is essential. Among these are the rules of the I.C.C., ICSID, UNCITRAL (U.N. Conference on International Trade Law). The following is a checklist of the most important items requiring consideration in designing arbitration provisions:

- (1) Description of arbitral issues;
- (2) Enforcement of award;
- (3) Appointment of arbitrators;
- (4) Language;
- (5) Governing law;
- (6) Entry of Judgment;
- (7) Time limits;
- (8) Neutral arbitrator versus tri-partite panel of arbitrators;
- (9) Costs; and
- (10) Place of hearings.

Do not assume that arbitration is necessarily preferable to court decision making. If the foreign joint venture partner can be persuaded to accept a Canadian forum and choice of law, there is a strong likelihood that leaving the ultimate resolution of disputes to the courts will be more satisfactory than arbitration. Court rules and procedures require no special definition by the parties. Canadian courts are usually accessible in a reasonable period of time.

The assistance of Legal counsel is most important in all matters relating to the resolution of disputes by legal process, including arbitration.

WINDING UP

If the differences between the parties cannot be resolved by informal negotiations or by mechanisms provided for in the joint venture, one party to a joint venture may apply to the court, under the authority of the incorporating statute, for an order appointing a receiver to wind up the corporation. The Ontario statute provides that the court may make such an order in situations, among others, where it is satisfied that a unanimous shareholder agreement entitled a complaining shareholder to demand dissolution after the occurrence of a specified event which has occurred or it is "just and equitable" for some reason other than bankruptcy or insolvency that the corporation be wound up.

Winding-up by court order is a last resort. The proceedings may be long, bitter and expensive. They almost certainly attract unwanted publicity. Moreover, the outcome is likely to be less satisfactory to either party than a negotiated or arbitrated settlement.

EFFECT OF TERMINATION

However remote termination may seem at the outset, adequate provision must be made for eventual termination. The most important matters to be anticipated are the further use of the name given to the venture, distribution of property (including the return of technology), and maintenance of confidentiality.

TAX FACTORS AFFECTING CANADIAN JOINT VENTURES

In this section we summarize those features of the Canadian system of taxation which have been found to be of most interest to the participants in a Canadian joint venture. For the Canadian business person it may serve as a refresher and checklist; for the foreign investor a useful introduction.

In Canada, income taxation at both federal and provincial levels must be considered. To keep this summary as concise as possible, we consider Ontario as representative of the provinces with occasional reference to others.

The material presented here is accurate as of September 29, 1989. In Canada, taxation is a field in which frequent change is the rule rather than the exception. There is no substitute for close consultation with professional advisors on tax matters as joint ventures are structured and implemented.

BASIS OF TAXATION

Residence

A corporation resident in Canada is subject to Canadian income tax on its worldwide income. A corporation incorporated and carrying on business in Canada is presumed to be so resident. Based on these principles, a Canadian joint venture corporation is subject to the basic scheme of Canadian corporate income taxation as described below.

Even if the Canadian joint venture as such is unincorporated, it is common for the foreign investor to form a Canadian subsidiary corporation which becomes the actual joint venture participant. The same basic principles of Canadian corporate income taxation apply to such a corporation.

RATE OF CORPORATE TAXATION

Full Rate

The tax rates discussed below are applied to the corporation's income, calculated generally according to ordinary accounting principles, plus two-thirds (three-quarters after 1989) of capital gains.

The full rate of corporate income tax applied on income earned in a province is calculated by adding together the federal rate of 28% and the applicable provincial rate, which varies from province to province. In Ontario, a corporation subject to the full corporate rate pays the federal income tax of 28% and Ontario income tax of 15.5% for a combined federal and Ontario tax rate of 43.5%. In addition, a 3% federal surtax is imposed on corporate income.

Reduced Rate

A "Canadian-controlled private corporation" is entitled to take a "small business deduction" which results in a lower rate on a portion of its income. If the foreign voting control of a Canadian joint venture corporation does not exceed 50%, then the corporation may qualify as a Canadian-controlled private corporation and obtain this reduced rate. Another condition is that the corporation seeking the reduced rate must not be directly or indirectly controlled by a corporation whose shares are listed on a Canadian stock exchange. It is a considerable selling point to some potential foreign investors that they may obtain up to a full 50% of the voting shares of a Canadian corporation without displacing the small business deduction.

The small business deduction reduces the federal tax rate by 16%. The provinces also give a small business deduction, so the combined effect of the federal and provincial rules must be taken into account. In Ontario, the small business deduction has normally reduced the provincial rate to 10%, resulting in a combined federal and Ontario rate of 22%.

This reduced rate is applied to the first \$200,000 of active business income earned in Canada in the year.

SPECIAL RATE FOR MANUFACTURING AND PROCESSING

A corporation which carried on eligible manufacturing or processing activities in Canada may be entitled to a reduced rate of taxation of the

resulting income.

The term "manufacturing and processing" is not defined. Certain activities, such as fishing, farming, logging, construction and a number of resource-related activities, are specifically excluded. Further, a corporation is not entitled to a manufacturing and processing tax credit if less than 10% of its gross revenue for the year from active businesses carried on in Canada are from manufacturing or processing goods in Canada or from selling or leasing goods it has manufactured or processed in Canada. Generally speaking, if a corporation's activities fall within the everyday meaning of the words "manufacturing" or "processing", it will qualify for the reduced rate.

The rate of federal taxation on manufacturing and processing income is 25%.

The combined federal and provincial rate in Ontario is currently 44% (including surtaxes) for a corporation eligible for the manufacturing and processing rate, but not for the small business deduction.

CAPITAL GAINS REALIZED BY THE VENTURE

Two-thirds (three-quarters after 1989) of realized capital gains are included in computing a taxpayer's income which, if the taxpayer is a corporation, are then taxed at the full corporate rate. Capital gains arise when the proceeds realized on the disposition of capital property exceed the cost of the property plus any costs of disposition.

DEPRECIATION AND RECAPTURE

Taxpayers are entitled to depreciate the cost of assets acquired by them for the purpose of producing income from property or business. In Canada depreciable property is categorized by class and a maximum rate of depreciation (called "Capital Cost Allowance") is prescribed in respect of each class. In general, depreciation is calculated on a diminishing balance basis but there are exceptions to the rule where the "straight-line" method of depreciation is applicable. Where the taxpayer disposes of an asset on which he has claimed depreciation he will "recapture" the amount of depreciation previously deducted and will be required to include that amount in income.

In certain instances, a taxpayer may be entitled to an accelerated rate of depreciation.

WITHHOLDING TAX ON ROYALTIES

If joint venture arrangements include a license from the foreign participant to the venture under which royalties are payable, a so-called "withholding tax" will be payable to Canada as such fees are paid. This is the same withholding tax which applies where the licensor is an unrelated party and is discussed at page 56.

WITHHOLDING TAX ON MANAGEMENT FEES

A foreign joint venture partner sometimes expresses interest in extracting compensation from the venture on a pre-tax basis in the form of management or administration fees. A discussion of management and administration fees appears on page 57.

WITHHOLDING TAX ON DIVIDENDS

Dividends paid by a Canadian corporation to a foreign shareholder are subject to a Canadian non-resident withholding tax which is set at 25% under the Income Tax Act but reduced to 15% for payments to countries with which Canada has entered into tax treaties. These countries are listed on page 42.

EXPENSES OF THE JOINT VENTURE

For the incorporated joint venture, the expenses of doing business are deducted from the corporation's revenues in the process of calculating the income which is subject to tax according to generally-accepted accounting principles. In this connection, special note should be taken that an immediate write-off is allowed for all research and development expenditures. In addition, there is an investment tax credit for research and development expenditures ranging from 20% to 35%.

PARTNERSHIP

If joint venturers decide to carry on business as partners, the income (or loss) of the business will be calculated at the partnership level as if the partnership were a separate person.

All applicable deductions from the

partnership business must be taken at the partnership level. However, liability for tax on partnership profits flow through to the members in accordance with their entitlement to the profits or losses of the partnership.

One type of expense which must be claimed at the partnership level is depreciation. This may be disadvantageous if one of the partners does not wish to claim maximum depreciation in the year. One of the reasons parties contemplating an unincorporated joint venture usually choose to combine their resources on a non-partnership basis is to ensure that deductions for tax purposes are available at the participant level. Since the Income Tax Act contains no specific rules regarding computations of the income of such an unincorporated, non-partnership joint venture, it would appear that each joint venture participant is free to calculate his income and losses from the joint venture separately.

TAX CONSEQUENCES OF TRANSFERRING JOINT VENTURE EQUITY

Under the Income Tax Act, two-thirds (three-quarters after 1989) of the gain realized by a non-resident on the sale of his interest in a Canadian joint venture will generally be included in computing the non-resident's income for Canadian tax purposes. The non-resident may, however, escape Canadian tax altogether if he is resident in a country which has a tax treaty with Canada whereby such gains are exempt. Under the terms of the Canada-U.S. tax treaty, for example, a resident of the U.S. who sells his interest in a Canadian joint venture will not be taxable in Canada on any gains realized provided that he has no "permanent establishment" in Canada in the year of the sale.

DEDUCTIBILITY OF INTEREST ON LOANS FROM JOINT VENTURE PARTICIPANTS

If the parties to a corporate joint venture intend to capitalize the corporation partly by way of direct interest-bearing loans, they should be aware of a possible limitation on the joint venture corporation's ability to deduct the interest expense. Simply stated, to the extent that interest on funds borrowed from non-arm's length lenders exceed more than three times the equity of the joint venture corporation, the joint venture corporation is not entitled to deduct the interest expense on the excess.

INVESTMENT CANADA

Transfers of technology to Canada from abroad by way of sale, technical assistance or licensing arrangements are not subject to any formal notification or review procedures. However, non-Canadian involvement in business operations in Canada may require either notification or review pursuant to the Investment Canada Act.

If a non-Canadian investor establishes a new business in Canada, which he will control, he must file a simple notification in prescribed form with Investment Canada, an agency of the Department of Industry, Science and Technology. The notification must identify the investor and the nature of the new business. If such new business is related to Canada's cultural heritage or national identity, its establishment is subject to review at the discretion of the Government. The review procedure is discussed below.

The Investment Canada Act requires the Government of Canada to define by regulation what is meant by the expression "cultural heritage or national identity".

If a non-Canadian investor acquires control of an existing Canadian business, he is similarly required to file notification thereof with Investment Canada. If the transaction exceeds certain threshold levels, measured by the Canadian dollar value of the gross assets of the business being acquired, it will be subject to review.

The threshold levels which give rise to review of acquisition transactions are as follows:

- (1) if the investor is acquiring direct control of a Canadian business, either by purchase of shares or assets, gross assets of \$5-million or more;
- (2) if the investor is acquiring indirect control of a Canadian business, gross assets of \$50-million or more except in circumstances where the assets of the Canadian business represent more than 50% of the total international transaction, in which event the threshold level is \$5-million as in the case of direct acquisitions.

Pursuant to the Canada-U.S. Free Trade Agreement, the threshold level which gives rise to review of direct acquisitions of Canadian businesses by U.S. investors will be increased on

the following stages:

Effective Date	Gross Asset Value Threshold (Cdn.\$)
January 1, 1989	25,000,000
January 1, 1990	50,000,000
January 1, 1991	100,000,000
January 1, 1992	150,000,000
and thereafter	(in constant 1992 Cdn.\$)

The review of indirect acquisitions by U.S. investors will be phased out in the following manner:

Effective Date	Gross Asset Value Threshold (Cdn.\$)
January 1, 1989	100,000,000
January 1, 1990	250,000,000
January 1, 1991	500,000,000
January 1, 1992	
and thereafter	no review

Investments relating to the provision of transportation, financial services and cultural industries are excluded from the increased threshold levels.

Since the notification and review requirements of the Investment Canada Act only apply where a non-Canadian is establishing or acquiring a Canadian business which he will control, the key concept of control must be clearly understood. The Act contains special provisions to assist the investor to determine the circumstances in which non-Canadian control of a business is considered to arise.

It is clear that a non-Canadian holding more than 50% of the voting interest in an incorporated or unincorporated joint venture will be considered to be in a position of control. Under the special rules contained in the Investment Canada Act, foreign holdings of one-third or more of the voting shares of an incorporated joint venture are presumed to constitute control unless negated by facts which show that such holdings do not represent actual control. Interests by non-Canadians in an incorporated or unincorporated joint venture will not constitute control if a single Canadian individual or entity holds more than 50% of the voting interests. However, if the Canadian interests are divided, the minority voting interest

may constitute control on a theory of negative control.*

The Investment Canada Act provides time constraints which are important in both the notification and review procedures. In cases where notification is required, notice must be given to Investment Canada prior to the implementation of the investment or within thirty days thereafter. If the Minister responsible for the Investment Canada Act intends to review the investment as one related to Canada's cultural heritage or national identity, he is required to advise the non-Canadian investor of such intention within twenty-one days of receiving the investor's notification.

Generally, a non-Canadian proposing to make a reviewable investment must file an application for review and receive approval prior to implementation of the investment.*

An application for review must provide a description of the investor's plans for the Canadian business, comparing them with the current operations of the business. The completed application is examined by officers of the Investment Canada Agency, then referred to the Minister along with any undertakings which the applicant may submit to support the application and any representations submitted to the Agency by a province affected by the investment. The Minister must then make a decision within forty-five days but may unilaterally extend this time constraint for another thirty days by notifying the applicant of his intention to do so.

The purpose of review is to ensure that the acquisition will be of net benefit to Canada. In making his decision, the Minister is permitted to consider the following factors:

- (1) the effect of the investment on the level and nature of economic activity in Canada;
- (2) the degree and significance of participation by Canadians;
- (3) the effect of the investment on productivity, industrial efficiency, technological development, product innovation and product variety in Canada;
- (4) the effect of the investment on competition within any industry or industries in Canada;
- (5) the compatibility of the investment with national industrial, economic and cultural policies;
- (6) the contribution of the investment to Canada's ability to compete in world markets.

* An accurate reading on the merits of a particular proposal can be obtained by prior consultation with experienced counsel, provincial government officials and the Investment Canada Agency.

The Investment Canada Act charges the Minister responsible for its administration with a positive responsibility to provide investment information services to facilitate economic growth in Canada. The Act therefore encourages consultation with the Minister and Agency at any time.

There are numerous business arrangements between Canadians and non-Canadians which do not fall within the scope of the Investment Canada Act. The following is a partial list of such relationships:

- (1) Direct export of products to Canadian customers upon receipt of purchase orders.
- (2) Sale of foreign-manufactured products in the Canadian market through independent Canadian distributors, who may conceivably handle the particular line of products on an exclusive basis.
- (3) Solicitation of sales in Canada by an independent sales representative.
- (4) Contract manufacturing in Canada by independent manufacturers and distribution by one of the methods previously mentioned.
- (5) "One-shot" projects of less than one year's duration.

A requirement for review of a joint venture proposal pursuant to the Investment Canada Act should not in any event be a matter for undue concern. Government policy favors foreign investment and joint venture operations.

FREE TRADE

THE CANADA-U.S. FREE TRADE AGREEMENT

The Canada-United States Free Trade Agreement (the "FTA") came into effect in both countries on January 1, 1989. The FTA is a comprehensive free trade area agreement consistent with Article XXIV of the General Agreement on Tariffs and Trade (the "GATT") which means that Canada and the United States (the "Parties") have agreed to eliminate customs duties and other restrictive regulations of commerce on "substantially all the trade" in goods between the two countries. Unlike a customs union such as the European Economic Community, the FTA does not require Canada and the U.S. to develop a common trade policy with respect to their trade relations with other countries.

The FTA is unique among the free trade agreements negotiated to date in the breadth of its scope. It provides not only for the elimination of tariff and non-tariff barriers to the trade of goods but also contains provisions dealing with such non-traditional areas as investment, services, financial services, technical standards, government procurement and business travel. Although the measures agreed to in these new areas are somewhat modest, they establish an important precedent for the development of new international rules in the Uruguay Round of GATT negotiations. In addition, the FTA contains special mechanisms for the resolution of bilateral trade disputes.

With regard to the new areas covered by the FTA, such as services and investment, the guiding principle is that of national treatment. As one of the keystones of the GATT, this principle has traditionally applied only to trade in goods. The national treatment rule means that Canada and the U.S. will treat each other's investment and services as they treat their own. National treatment does not mean that the Parties will harmonize their respective laws, but rather that each Party will treat the other Party's services and investments no less favorably than it treats its own.

ELIMINATION OF TARIFFS

Pursuant to the FTA, Canada and the United States have agreed to eliminate over a nine-year period, which commenced January 1, 1989, all bilateral tariffs on goods meeting stipulated rule of origin requirements. The tariffs on certain goods were eliminated on January 1, 1989. The tariffs on other goods will be eliminated in five equal annual stages or ten equal annual stages, with the first reduction having occurred on January 1, 1989. Moreover, by mutual agreement, Canada and the United States may accelerate the elimination of tariffs applicable to specific goods.

RULES OF ORIGIN

In order to qualify for the tariff reductions under the FTA, goods must meet certain rules of origin described below.

(a) Goods Must be Wholly-Obtained or Produced in the Free-Trade Area

The first general rule of origin is that the goods must be "wholly-obtained or produced" in the free-trade area.

Goods "wholly-obtained or produced" in the free-trade area include:

- minerals mined in the free-trade area;
- goods harvested in the free-trade area;
- marine life taken by Canadian or U.S. vessels;
- live animals born and raised in the free-trade area; and
- goods produced in the free-trade area exclusively from such goods or their derivatives.

(b) Goods Must be Transformed Within the Free-Trade Area

Many goods will not meet the first test because they are manufactured or assembled using raw materials or components originating outside the free-trade area. Such goods will qualify for duty free treatment if they have been "transformed" in the free-trade area.

- Goods are "transformed" if:
 - they are classified differently under the Harmonized Commodity Description and Coding System (the "H.S.") from the raw materials or components from which they have been made; and
 - for certain goods, the direct cost of producing or assembling the goods, plus the value of materials originating in Canada or the U.S. which are used in the production or assembly of the goods, is a prescribed percentage of the value of the goods when exported to the other Party.

(i) Goods Must Undergo Change in Tariff Classification

The basis for tariff classification under the FTA is the H.S. The H.S. is an international classification system developed by the Customs Co-Operation Council and adopted by most of the major trading nations. The H.S. is composed of 21 sections which are divided into 99 chapters. The 99 chapters are in turn divided into headings and subheadings.

In Canada, the H.S. came into force on January 1, 1988, while the U.S. implemented the H.S. as the basis for its customs tariff on January 1, 1989.

Annexes to the FTA prescribe the degree of change in classification necessary to qualify for duty free treatment. For example, certain goods produced or assembled in the free-trade area from imported materials or components must be classified in a chapter other than a chapter in which the materials or components themselves are classified. For other goods, changes between headings or subheadings are required. In addition, certain changes between chapters, headings and subheadings are specifically excluded.

Goods which have undergone processing or assembly in either the U.S. or Canada, or both, thereby attaining the prescribed degree of transformation will not qualify under the rules of origin if such goods have subsequently undergone further processing or assembly outside the free-trade area. Therefore, for example, goods finished in Mexico under its "maquiladora" program will not qualify for free trade treatment, even if they are sufficiently transformed.

(ii) Certain Goods Must Have Local Content

Certain goods must not only meet the change in classification test, but in addition, the value of materials originating in the free-trade area, plus the direct cost of producing or assembling the goods

incurred in the free-trade area must constitute a prescribed percentage (generally not less than 50%) of the value of the finished goods. These goods include products of the chemical or allied industries, plastics, rubber, certain base metals and articles manufactured from base metals, footwear, automobiles, machinery and electrical equipment.

Materials are goods which are used or consumed in the production of other goods. The value of the materials originating in the free-trade area is the price paid by the producer of the goods in question for materials which qualify under the rules of origin, or the price paid by such producer for materials which are imported from third countries and are used or consumed in the production of materials which qualify under the rules of origin.

When not included in the price paid for such materials, the following amounts are added:

- freight, insurance, packaging, and all associated transportation costs in transporting the materials to the producer's premises;
- duties, taxes and brokerage fees on the materials paid in either the U.S. or Canada;
- the cost of waste or spoilage incurred in the use or consumption of the materials less the value of renewable scrap; and
- the value of certain "assists" supplied by the purchaser of the materials including components, parts, tools, dies and molds used in the production of the materials, and engineering, artwork and design work undertaken in countries other than the free-trade area and necessary for the production of the materials.

With respect to the second component of local content, the direct cost of processing or assembly means the costs that are directly incurred in, or that can be reasonably allocated to the production of the goods. Such costs include:

- all labor costs;
- costs incurred in inspecting and testing the goods;
- energy costs;
- depreciation and maintenance on machinery and equipment regardless of their origin;
- the cost of all dies, molds and tooling;
- development, design and engineering costs;
- rent, mortgage interest, building depreciation, property insurance premiums, maintenance, taxes and the cost of utilities for real property used in the production of the goods; and
- royalty, licensing, or other similar payments for the right to the goods.

The direct cost of processing or assembly does not include:

- general expenses such as sales and advertising expenses, accounting and legal expenses or insurance;
- brokerage charges relating to the importation or exportation of the goods;
- communication expenses (telephone, mail, etc.);
- export packaging charges;
- royalty payments for the right to distribute or sell the goods;
- rent, mortgage interest, building depreciation, property insurance premiums, maintenance, taxes and cost of utilities for real property used by personnel engaged in administrative functions; and
- profit on the sale of the goods.

The value of the goods when exported to the territory of the other Party is the aggregate of the price paid by the producer for all the materials used to produce the goods regardless of their origin (including the additional amounts referred to above in the discussion of the value of materials originating in the free-trade area) plus the direct cost of processing or assembly.

Where assembly does not result in a change of tariff classification because components of the finished goods are classified as unassembled or disassembled goods pursuant to General Rule of Interpretation 2(a) of the H.S., or because the tariff subheading under which the finished goods are classified includes "parts", the finished goods will nevertheless qualify under the rules of origin if:

- they meet the 50% content test; and
- subsequent to their assembly, they have not been further assembled or processed outside the free-trade area.

(c) Packaging, Dilution, Circumvention

Goods will not meet the rules of origin outlined above merely by virtue of having undergone simple packaging, dilution with a substance that does not materially alter the characteristics of the goods, or any process where it is established that the sole object was to circumvent the rules of origin.

While the FTA does not deal specifically with the transfers of technology between Canada and the U.S., the liberalized trading environment between Canada and the U.S. will likely result in greater opportunities for licensing and joint ventures with Canadians.

APPENDIX III-A

Checklist for License Agreements

Parties

Name of licensor _____
Address _____
Principal office _____
Incorporated in _____
Short title _____
Name of licensee _____
Address _____
Principal office _____
Incorporated in _____
Short title _____

Recitals

Licensor owns inventions ____ patents ____
patent applications ____ industrial designs ____
trademarks ____ know-how ____
Licensor represents that it has the right to grant a
license relating to _____
Licensee represents _____
Licensee desires license relating to _____

Definitions

Define "the products" covered by a limited license.
If certain types of inventions only are covered,
define "the inventions". Define "patents",
"trademarks", "registered designs", "copyrights",
"know-how", "net sales", "territory". Adopt other
defined terms as needed.

Date of Agreement

From date hereof _____
From some specific date _____
Effective date _____
When approved by _____

Grant

Patents _____
Trademarks _____
Registered designs _____
Copyright _____
Know how _____
Existing future improvements by licensor _____
In licensed inventions _____
or know how _____
In same field or _____
for similar applications _____
All rights to use know-how and practise
inventions ____ and to make, use and sell
products _____
Exclusive _____
Exclusive except as to licensor _____

Exclusive for ___ years and non-exclusive thereafter

Non-exclusive _____

Irrevocable _____

With right to grant sub-licenses _____

To make (manufacture) _____

To have made for own use _____

Unlimited _____

To use _____

To sell _____

To lease _____ rent _____

Nature of know-how

Invention records

Laboratory records

Research reports

Development reports

Engineering reports

Pilot plant design

Production plant design

Production specifications

Raw material specifications

Quality controls

Economic surveys

Market surveys

Promotion methods

Trade secrets

List of customers

Drawings and photographs

Models, tools and parts

Other (specify) _____

Know-how not confidential

Know-how confidential

Employees to be bound

Subcontractors and sublicensees to be bound

If patents held invalid:

Know-how payment stops

Know-how payment continues

Territory

All countries _____ all countries except _____

(specify) _____

Restrictions

Limited to specified field _____

Limited to specified territory _____

Subject to prior license _____

Subject to licensor's right to make _____

have made _____ use _____ sell _____

Sublicenses

To any other party _____

To nominees of licensor _____

At specified consideration _____

Limitations _____

Consideration to be shared with licensor _____

Copies to be furnished to licensor _____

Term

For _____ years.

Until (specify date) _____

Until some future event (specify) _____

For the life of any patent _____

Until specified notice of termination _____

Extension of term _____

Automatic unless notice of termination _____

Automatic if minimum performance achieved _____

Automatic except for terms (e.g. royalty rate) to be negotiated or arbitrated _____

Good faith negotiations to extend _____

Consideration

Lump sum payment _____

Single payment _____

Installments _____

Royalty, per cent of profits _____

gross sales _____

net sales, specific amount (specify) _____

per unit (specify) _____

other _____

Payment in Canadian dollars:

At then current rate of exchange

At rate of _____ dollars for _____ (foreign currency)

If exchange rate decreases or increases by 5% the payments shall decrease or increase by the like amount _____

Exchange rate shall be that published in _____

Payment in currency other than Canadian

Stock of licensee (specify) _____

Stock of existing company _____

new company _____

Value of the shares of stock shall be market value at date of agreement _____

book value _____

Stock shall have full voting rights _____

non-voting _____

Stock shall have value not less than \$ _____

Stock shall represent not less than _____ per cent of the issued shares

Licensor shall have the option to acquire additional shares at market value _____

book value _____

Licensor shall have option to appoint directors:

with full voting rights _____

non-voting _____

Minimum Royalty

Amount per calendar year _____
per 12-month period _____
Payable in advance _____
Payable at end of calendar year _____
of 12-month period _____
Credited against earned royalties:
Yes _____ No _____

Inspection of Licensee's Accounts

Not permitted _____
Permitted: _____
At any time during business hours _____
At specified times _____
By licensor's authorized representatives _____
By accountants _____

Acknowledgement of Licensor's Title

Not admitted _____
Admitted by licensee _____
If patents held invalid, then
Licensee may terminate:
as to invalid claims _____
entire agreement _____

Statements of Earned Royalty

Quarterly, within ____ days of end of quarter
Annually, within ____ days of end of year
Other periods (specify) _____
In writing and certified before notary public _____
With names and addresses of sublicensees _____
With copies of sublicenses _____
Together with payment of royalty accrued _____

Inspection of Licensee's Accounts

Not permitted _____
Permitted: _____
at any time during business hours _____
at specified times _____
by licensor's authorized representatives _____
by accountants _____

Acknowledgement of Licensor's Title

Not admitted _____
Admitted by licensee _____
If patents held invalid, then
Licensee may terminate:
as to invalid claims _____
entire agreement _____

Improvements by Licensee

Not included _____
Included for products (specify) _____
Automatically owned by licensor _____
Licensed to licensor automatic _____
Licensor's option-free royalty _____
For term of agreement _____
for specified term _____
For territory of license _____
for specified territory _____

Diligence by Licensee

No obligation _____
Licensee will use its best efforts _____
Licensee agrees to:
produce or ____ sell ____ specified units
produce ____ or sell ____ specified products
invest specified amount _____
satisfy demands of trade _____
refuse no reasonable request for sub-license _____
Penalty for lack of diligence:
License converted to non-exclusive _____
Licensor may nominate licensees _____
Licensor may terminate upon _____
days' notice in writing _____

Infringement

A. Licensed rights
Past infringement by licensee:
forgiven ____ not forgiven _____
forgiven for payment of _____
If infringed by others:
Who will notify _____
Who will file suit _____
Who is in charge of suit _____
Costs: borne by ____ divided _____

B. Rights of others
No indemnity by licensor _____
Licensor indemnifies licensee _____
Who will notify _____
Who will defend _____
Who will pay costs _____
Costs: borne by ____ divided _____

C. Damages
Retained by ____ divided _____

D. Right to settle suit:
by licensor ____ by licensee _____
by licensor only with consent of licensee _____

Right of Inspection

Licensor shall have the right to inspect licensor's:
research laboratory _____ development
laboratory _____ engineering laboratory _____
pilot plant _____ production plant _____
department relating to product _____
Number of visits permitted per year _____
Number of persons _____
Licensor shall have reciprocal
rights of inspection _____

Technical Personnel

Licensor shall provide technical personnel to
deliver know-how:
At licensor's expense _____
at licensee's expense _____
Not more than _____ persons
for not more than _____ days.
At a fee which shall be the salary,
plus _____ per cent.
Travel expenses _____ living expenses _____
borne by licensor _____ borne by licensee _____
Number and duration of stay of technical personnel
determined by:
Licensor _____ licensee _____
mutually _____

Confidentiality

No obligation _____ licensee obligated _____
both parties obligated _____
Without limitation as to time _____
life of agreement _____
until published by owner _____
Obligations of confidentiality of employees _____
sublicensees _____

Arbitration

No right of arbitration _____
Parties will use their best efforts _____
Parties agree to arbitration by:
specified body _____
three persons one selected by each party and a
third by the selected persons _____
Appeal from arbitration decision:
Not permitted, decision final and binding _____
Permitted to (specify tribunal) _____

Termination

By licensor:
If certain person incapacitated (name) _____
If certain person terminated connection with
licensee (name) _____
At specified time _____
Only upon breach after _____ days' written notice
By licensee:
At any time upon _____ days' written notice
On any anniversary date _____
At any specified time _____
Only upon payment of penalty of \$ _____
Only upon breach after _____ days' written notice
Upon termination, licensee assigns to licensor:
Trademarks _____ patents _____
sublicenses _____
As to any specified patent or applications _____
As to any specified country _____
Of exclusive license with right to continue as
non-exclusive _____
Whenever any essential claim held invalid _____
Upon bankruptcy of either party _____

Force Majeure

Licensor has right _____
Licensee has right _____
Both parties have right _____
Nature of force majeure
Natural events: fire, floods, lightning, wind-
storm, earthquake, subsidence of soil, etc.
Accidents: fire, explosion, failure of equipment,
transportation accidents
Civil events: commotion, riot, war, strike, labor
disturbances, labor shortages, raw material
and equipment shortages
Governmental: government controls, rationing,
court order
Any cause beyond control of party _____

Assignment of Agreement and License

Not assignable by either party _____
Assignable by licensor, without consent of
licensee _____ with consent _____
By either party:
Upon merger _____
To successor of entire business _____
To any company of which a majority of stock is
owned _____
To any company of which a controlling interest
is owned _____
Binding upon heirs, successors and assigns _____

Most Favored Licensee Clause

Licensor required to notify licensee of similar
license _____

Licensee has option to take term of similar license _____

License changed to terms of more
favorable license _____

Licensee may terminate _____

Notices and Addresses

By registered air mail _____

Licensor's legal address for notice _____

Licensee's legal address for notice _____

Provision for deemed notice _____

Integration

This instrument is the entire agreement between
parties _____

No modification effective unless written and
signed by both _____

This agreement supersedes:
all prior agreements between the parties
the agreement dated _____

Language

The official language shall be English _____
other _____ (specify) _____

Copy in _____ language shall be official
unofficial _____

Law Applicable

To be construed according to the laws of _____

Signatures

For individual:
"Hand and seal" _____

For corporations:
By officer _____
Title shown _____
Corporate seal _____

Schedules

Patent list (inventor, number, issue date, official
title) _____

Patent applications (inventor,
serial number, filing date, official title) _____

Industrial designs
(registration number and date) _____

Copyrights (description,
registration number and date) _____

Trademarks (description,
registration number and date) _____

Descriptions or copies of official documents, such
as sublicenses, assignment, prior license, etc. _____

Accounting procedures if any for determining
sales, net sales, sale value of stock, or other
property _____

TRADEMARK SUPPLEMENT

If the agreement is to include a trademark license,
check the following items:

LICENSED TRADEMARKS

Trademark Application No. and date _____

Trademark Registration No. and date _____

Classes of goods (specify) _____

Goodwill of business (specify) _____

THE GRANT TO USE

Exclusive _____ non-transferable _____

Countries Trademark Registration No. Date

Term of License**CONSIDERATION**

Royalty: % of profits _____ of gross sales _____
of net sales _____

Single sum of \$ _____ Annual minimum \$ _____

Included in know-how fee _____ not included _____

Stock of licensee (name company) at
market value _____ "book value" _____

PRODUCT QUALITY CONTROL

Mark to be used only on goods (specify) _____

Made under written specifications:
attached _____

to be supplied by licensor _____

No other trademarks to be used on same goods _____

Samples to be furnished upon request:
quarterly _____ annually _____

Inspection of product manufactured by licensor
permitted:

when requested _____ quarterly _____

annually _____

Liability for misuse:

Licensor liable _____ licensee liable _____

TRADEMARK USE CONTROL

Licensor has right to approve, in advance, use of
mark in:

Advertising _____

Labels _____

Containers _____

Registration notice _____

Exhibits _____

Speeches _____

Publicity _____

Corporate Signature _____

REGISTRATION IN TRADEMARKS OFFICE

Entire Agreement _____

Separate Registered User Agreement _____

APPENDIX III-B

Revenue Canada Interpretation

Bulletin No. IT-477

1. Paragraph 20(1)(a) of the Act and paragraph 1100(1)(c) of the Regulations allow a taxpayer to claim capital cost allowance in the manner described in 3 to 6 below in respect of property in class 14 of Schedule II to the Regulations (hereinafter referred to as "class 14 property"). Class 14 property is prescribed to be property that is a patent, franchise, concession or license for a limited period in respect of property but not including

- (a) a franchise, concession or license in respect of minerals, petroleum, natural gas, other related hydrocarbons or timber and property relating thereto (except a franchise for distributing gas to consumers or a license to export gas from Canada or from a province) or in respect of a right to explore for, drill for, take or remove minerals, petroleum, natural gas, other related hydrocarbons or timber,
- (b) a leasehold interest, or
- (c) a property that is included in class 23.

2. The general rules regarding capital cost allowance are not discussed in detail in this bulletin but it should be kept in mind that a property is not included in class 14 (or any other class of property described in Part XI and Schedule II of the Regulations) if it is a property described in subsection 1102(1) of the Regulations.

Calculation of Maximum Allowance

3. Pursuant to paragraph 1100(1)(c) of the Regulations, the maximum capital cost allowance available to a taxpayer in any year in respect of class 14 property is the lesser of:

- (a) the aggregate of the amounts obtained by apportioning the capital cost of each property over the life of the property remaining at the time the cost was incurred, or
- (b) the undepreciated capital cost to him as of the end of the taxation year of property of that class.

4. It is the Department's view that the apportionment of the cost of a class 14 property over the remaining life of the property under 3(a)

above should be on an equal, per diem basis. For example, if a one year franchise were purchased by a taxpayer on a calendar year basis on December 31, 1979, only one three hundred and sixty-fifths of the capital cost of the franchise would become available for depreciation under 3(a) above in 1979. Similarly, if a Canadian patent (having a 17 year life) is granted mid-way through a taxpayer's taxation year, one thirty-fourth of its capital cost would be apportioned to the first and eighteenth taxation years and one seventeenth of its capital cost would be apportioned to each of the sixteen taxation years in between.

5. Where less than the maximum allowance is claimed in a taxation year, the difference between the amount claimed and the maximum allowance for that year can be deducted only as a terminal loss under subsection 20(16) in a taxation year at the end of which the taxpayer owns no class 14 property. For example, if a taxpayer on a calendar year basis acquires a license on January 1, 1980 expiring on December 31, 1984, at a cost of \$1,000, and if this represents the only asset in class 14, he would be entitled to an allowance of up to \$200 per year. If only \$1 is claimed in 1980, the maximum allowance continues to be \$200 in subsequent years and the \$199 not claimed in 1980 would become deductible as a terminal loss in 1984 if no class 14 property is owned at the end of 1984.

6. Subsection 1100(3) of the Regulations which, in certain instances, requires capital cost allowance to be prorated over a short taxation year, does not apply to class 14 property.

Election in Case of Patent

7. Where the cost of a patent is determined wholly or partly by reference to the use of the patent, capital cost allowance may be claimed under subsection 1100(9) of the Regulations rather than under paragraph 1100(1)(c). Under this subsection, the taxpayer is permitted to deduct an amount, not exceeding the undepreciated capital cost of the property in class 14, of up to the aggregate of

- (a) the part of the capital cost of the patent determined by reference to the use of the patent in the year, and
- (b) the part of the capital cost of the class 14 property apportioned to the year under 3(a) above after excluding from capital cost any amounts determined by reference to the use of the patent in that year or previous years.

8. It should be noted that subsection 1100(9) of the Regulations applies to patents only and not to any other class 14 property. For instance, a license to use a patent will, if it is for a limited period, qualify as class 14 property but will not be eligible for the elective treatment under this subsection.

Definitions

9. In Canada, a patent is defined in the Patent Act as letters patent for an invention. Accordingly, no patent exists under that Act until the date the letters patent are granted and issued as noted on the face of the patent, and capital cost allowance is not available in respect of the cost of acquiring a patent while a patent is pending. The life of the patent in Canada is 17 years from the date the letters patent are granted and issued.

10. Foreign patents, that is those granted by a foreign government, may qualify as depreciable property in the same way as other foreign property. Reference is made to IT-205 in this regard. The relevant foreign law would govern in determining when the patent comes into existence, whether or not the patent is "for a limited term" and the "life of the property remaining at the time the cost was incurred" for the purposes of claiming capital cost allowance.

11. The words "franchise, concession or license", are not capable of easy definition. Generally, they must be given the meaning or sense in which they are normally employed by businessmen on this continent and they extend, not only to certain kinds of rights, privileges or monopolies conferred by or pursuant to legislation or by governmental authority, but also to analogous rights, privileges or authorities created by contract between private parties. Again, generally, these words are used to refer to some right, privilege or monopoly that enables the holder to carry on his business or earn income from property, or that facilitates the carrying on of his business or the earning of income from property. These words do not extend to a contract under which a person is entitled to remuneration for the performance of specified services, nor to a covenant not to compete for a limited period.

12. A trademark does not qualify as a class 14 property. (See IT-143R.)

Expectation of Class 14 Property

13. A payment made to obtain a patent, franchise, concession or license is included in the capital cost

of the property whether made to the actual grantor or to a holder of such property in order that he will relinquish it in favor of the payer. Where, however, a taxpayer pays an amount, either separately or as part of a payment to acquire the business or assets of another person, for which he does not obtain an existing patent, franchise, concession or license but only the right to stand in place of that other person in applying for such a property or for a renewal thereof, no part of that amount is paid for property of class 14; such amount may, however, qualify as an eligible capital expenditure for the purposes of section 14. An example would be where a taxpayer pays an amount to a vendor for a licensed taxicab where the license is not transferable but he fully expects that the licensing authority will issue a new license to him. Such amount would not be depreciable as the taxpayer is paying for a mere expectation of being granted a license.

"Life of the Property" and "Limited Period"

14. Property that is a patent, franchise, concession or license qualifies under class 14 only if it is for a "limited period", and its cost is depreciable, pursuant to paragraph 1100(1)(c) of the Regulations, "over the life of the property remaining at the time the cost was incurred". That is, it must be for a period capable of being ascertained at the time the cost was incurred. For example, under the Copyright Act, copyright in a work generally subsists for the life of the author and fifty years after his death. As the period during which the author may live is not ascertainable during his lifetime, a taxpayer may only include in class 14 a copyright acquired after the death of the author. On the other hand, a license for a limited term of up to 50 years under a copyright granted before the author's death would be depreciable.

15. The provisions of a franchise, concession or license concerning renewals or extensions following the original term are relevant in determining the life of the property and whether or not the property is for a limited period. Where such renewals or extensions are automatic or within the control of the taxpayer, that is they do not require any further negotiation with or the concurrence or consent of the grantor, the life of the property includes such additional periods. For instance, where a franchise with an initial term of 5 years can be renewed at the option of the franchisee for one further 3-year period, the life of the franchise is 8 years. On the other hand, where the concurrence of the franchisor is required, the life of the property does not include any renewal period. Where the

taxpayer has an option to renew or extend the term only if certain conditions are met, for instance meeting certain performance or sales criteria, the circumstances of the particular case must be examined to determine whether or not, when he acquired the property, it was reasonably certain that these conditions would be met. If so, the additional periods are included in the life of the property.

16. Where renewal or extension periods are considered part of the life of the property under the criteria set out in 15 above, and where the number of such renewals or extensions is indefinite, the property is not for a limited period and does not qualify as a class 14 property. Where the number of such renewals or extensions is definite, for example, where a license is for an initial term of 5 years and the licensee has options to renew the license for two further 3-year periods, the property is for a limited term, in this example 11 years. The number of renewals or extensions may, in fact, be limited in certain circumstances even if the relevant agreement does not expressly provide such limits. For instance, a license under a Canadian patent under which the licensee has unlimited rights of renewal has a limited life because the life of the patent is itself limited to 17 years.

17. Provisions, including force majeure and contingency termination clauses, which may result in an early termination of the life of a property are not considered relevant in determining the life of the property and whether or not the property is for a limited period. For example, a franchise with an initial term of 5 years containing an option exercisable by the franchisee to renew for one further period of 5 years is for a limited period, namely 10 years, notwithstanding that the franchisor may become entitled to terminate the franchise agreement upon giving 60 days notice.

Industrial designs

18. Under the Industrial Design Act, an industrial design is protected for a period of 5 years from the date of registration subject to renewal for a further period of up to 5 years. A registered industrial design is considered to be a franchise for a limited period and the life of the property on initial registration is 10 years.

Capital cost

19. The capital cost of a class 14 property includes the purchase price, if any, and any legal fees and disbursements, registration fees and representation expenses laid out to acquire the

property. Expenses paid in a year in making a representation, relating to a business being carried on by a taxpayer, to a government, government agency or other body referred to in paragraph 20(1)(cc), including any representation for the purpose of obtaining a license, permit, franchise or patent, are deductible under paragraph 20(1)(cc) (or, if an election is made, under subsection 20(9)). However, if the representation expense was laid out to acquire a class 14 property, it will also form part of the capital cost thereof. To avoid a further deduction under paragraph 20(1)(a) in respect of the same amount and to permit recapture of the expenditure, subsection 13(12) deems the amount deducted under paragraph 20(1)(cc) (or in respect of which an election has been made under subsection 20(9)), to the extent that it forms part of the capital cost of the property, to have been allowed as capital cost allowance.

20. Where expenses related to the acquisition of a class 14 property are incurred in a year prior to the year in which the property is acquired, they will be added to the capital cost of the property in the year of its acquisition. No claim for capital cost allowance may be made in a year prior to the year of the actual acquisition of the relevant property.

21. The capital cost to the original owner of a patent or industrial design includes research and development expenses incurred in discovering, designing or developing the property to the extent that such expenses have not already been deducted as scientific research expenditures or ordinary operating expenses in the computation of income.

22. Once the invention or design has been developed to the point where a patent or an industrial design registration can be obtained, subsequent expenses for the purpose of turning the property to account would not form part of its capital cost.

APPENDIX III-C

Withholding Tax on Royalties

Applicable Provisions of Income Tax Act

212(1) Tax — Every non-resident person shall pay an income tax of 25% on every amount that a person resident in Canada pays or credits, or is deemed by Part I to pay or credit, to him as, on account or in lieu of payment of, or in satisfaction of,

Sec. 212(1)(d)

- (d) Rents, royalties, etc. — rent, royalty or similar payment, including, but not so as to restrict the generality of the foregoing, any payment
- (i) for the use of or for the right to use in Canada any property, invention, trade name, patent, trade mark, design or model, plan, secret formula, process or other thing whatever,
- (ii) for information concerning industrial, commercial or scientific experience where the total amount payable as consideration for such information is dependent in whole or in part upon
 - (A) the use to be made thereof or the benefit to be derived therefrom,
 - (B) production or sales of goods or services, or
 - (C) profits,
- (iii) for services of an industrial, commercial or scientific character performed by a non-resident person where the total amount payable as consideration for such services is dependent in whole or in part upon
 - (A) the use to be made thereof or the benefit to be derived therefrom,
 - (B) production or sales of goods or services, or
 - (C) profits,but not including a payment made for services performed in connection with the sale of property or the negotiation of a contract,
- (iv) made pursuant to an agreement between a person resident in Canada and a non-resident person under which the non-resident person agrees not to use or not to permit any other person to use any thing referred to in subparagraph (i) or any information referred to in subparagraph (ii), or
- (v) that was dependent upon the use of or production from property in Canada whether or not it was an instalment on the sale price of the property, but not including an instalment on the sale price of agricultural land, but not including
- (vi) a royalty or similar payment on or in respect of a copyright in respect of the production or reproduction of any literary, dramatic, musical or artistic work,
- (vii) a payment in respect of the use by a railway company or by a person whose principal business is that of a common carrier of property that is railway rolling stock as defined in the definition "rolling stock" in section 2 of the Railway Act
 - (A) if the payment is made for the use of that

property for a period or periods not expected to exceed in the aggregate 90 days in any 12 month period, or

- (B) in any other case, if the payment is made pursuant to an agreement in writing entered into before November 19, 1974;
- (viii) a payment made under a bona fide cost-sharing arrangement under which the person making the payment shares on a reasonable basis with one or more non-resident persons research and development expenses in exchange for an interest in any or all property or other things of value that may result therefrom,
- (ix) a rental payment for the use of or the right to use outside Canada any corporeal property, or
- (x) any payment made to a person with whom the payer is dealing at arm's length, to the extent that the amount thereof is deductible in computing the income of the payer under Part I from a business carried on by him in a country other than Canada.

APPENDIX III-C-CONTINUED

Revenue Canada Interpretation
Bulletin No. IT-303

1. This Bulletin outlines the Department's position with respect to the taxation of payments by persons resident in Canada to non-residents for what is commonly referred to as "know-how".
2. It should be noted that payments by a non-resident payor to a non-resident payee may be subject to Canadian tax if the payor is deemed by subsection 212(13) or 212(13.2) to be resident of Canada for the purposes of section 212 or Part XIII. Where a partnership pays or credits an amount (other than a capital expenditure or other non-deductible payment) to a non-resident person, paragraph 212(13.1)(a) deems that partnership to be a person resident in Canada and therefore obligated to withhold tax as required under section 212. In addition, where a resident person pays or credits an amount to a partnership that is not a Canadian partnership because not all of its members are resident in Canada, paragraph 212(13.1)(b) deems that particular partnership to be a non-resident person and therefore subject to tax under section 212.
3. No all-inclusive definition of "know-how" payments exists, but for the purposes of this

Bulletin, the Department regards them as including payments for special knowledge, skills or techniques which are considered beneficial in the conduct of a business. Such payments may be for expertise flowing from experience, ability or research which may be reflected in blueprints, drawings, specifications, plant layouts, designs, secret processes and formulae.

4. Paragraph 212(1)(d) provides for an income tax of 25% on all amounts paid or credited to a non-resident person as, on account or in lieu of payment of, or in satisfaction of, rent, royalty or a similar payment (other than an incremental resource royalty or an incremental production royalty as defined in subsection 79(1) of the Petroleum and Gas Revenue Tax Act paid or credited after 1981). The types of payments subject to tax under paragraph 212(1)(d) include, but are not limited to, those described in subparagraphs 212(1)(d)(i) to (v) but do not include those described in subparagraphs 212(1)(d)(vi) to (x). The provisions of bilateral tax agreements between Canada and other countries may reduce the rate of this tax or, in some cases, wholly exempt some payments (see 34 and 35 below).

5. Paragraph 212(1)(d) covers many payments which fall outside of "know-how" and similar payments and which are therefore beyond the scope of this Bulletin. Any rent, royalty or similar payment, whether it be for "know-how", for the use of confidential technical information, or for any other consideration, is subject to tax under paragraph 212(1)(d) unless it falls within the exceptions described in subparagraphs (vi) through (x). This means that if an amount is rent, royalty or a similar payment, it need not fall within the specific cases enumerated in subparagraphs (i) through (v) in order to attract withholding tax.

6. In addition to the foregoing, know-how payments may be exempt from withholding tax where the non-resident carries on business in Canada (see paragraph 25 below).

7. The Department considers that the words "rent" and "royalty" are used in a broad sense and are not necessarily restricted to periodic payments, but may in certain circumstances include single or lump-sum payments. In general, a rent or royalty represents a payment made to the owner of property for the right to use such property for a given period of time. In most circumstances where a rent or royalty is paid, the owner of the property

used by the person paying the rent or royalty retains ownership. However, where property in Canada is sold and payment is dependent upon the use of or production from the property, this payment will be subject to tax under subparagraph 212(1)(d)(v), unless the property is agricultural land.

8. The Department also considers that,
(a) apart from the circumstances set forth in subparagraph 212(1)(d)(x) (see para. 33 below), the deductibility under Part I of a payment for "know-how" by the person making the payment has no bearing on whether it is subject to withholding tax; and
(b) the taxability of the payment under paragraph 212(1)(d) does not depend upon whether or not the recipient would have been taxable in respect of the payment had he been resident in Canada.

9. The words immediately following the introductory words in paragraph 212(1)(d), namely "...including, but not so as to restrict the generality of the foregoing, any payment..." have the effect of including within the scope of the provision the payments described in subparagraphs (i) through (v), which need not be rent, royalty or a similar payment.

Payments for the Right to Use in Canada (subparagraph 212(1)(d)(i))

10. This provision extends to any payment, including a single or lump-sum payment, made to a non-resident for the right to use, in Canada, any property, invention, trademark, design or model, plan, secret formula, process, trade name, patent or other thing whatever. Such payment will be subject to tax whether or not it falls within the category of rent, royalty or a similar payment.

11. Some common examples of payments which fall within this subparagraph are:

- (a) franchise payments which encompass the use of trademarks, trade names or industrial designs;
- (b) payments for the use of blueprints for the layout of plants, buildings or equipment;
- (c) payments for the right to use special procedures, processes or recipes pertaining to business, whether or not incorporated in a franchise, patent or trademark; and
- (d) payments for the use of or the right to use prototypes or designs for manufacture in Canada.

12. On the other hand, the Department does not regard the following payments as falling within the provisions of subparagraph 212(1)(d)(i):

- (a) payments for the outright purchase of a patent;
- (b) payments made to obtain an outright assignment of an existing license from the licensee.

In the latter case, however, payments required to be made to the licensor under the terms of the license may be subject to withholding tax. If the payments under (a) or (b) are dependent upon the use of or production from the patent or license, tax is payable under subparagraph 212(1)(d)(v).

13. The Department also draws a distinction between payments which are made for the right to use property, inventions, etc. in Canada and payments which are made for services over and above the granting of the right to use such property. The former payments will be subject to tax under subparagraph 212(1)(d)(i), whereas the latter may be subject to tax under subparagraph 212(1)(d)(iii), depending upon the terms of the payments.

Payments for Information (subparagraph 212(1)(d)(ii))

14. Under this provision, any payment for information concerning industrial, commercial or scientific experience will be subject to tax where the total amount payable as consideration for such information is dependent in whole or in part upon:

- (a) the use to be made thereof or the benefit to be derived therefrom;
- (b) production or sales of goods or services, or
- (c) profits.

15. Such payments will be taxable regardless of where the information is obtained or used except in the circumstances contemplated in subparagraph 212(1)(d)(x) where a portion of the amount is deductible in computing the income of the payor under Part I from a business carried on by him in a country other than Canada (see paragraph 33 below). Similarly, taxability does not necessarily rest upon the payment being dependent on use, production or profits of the person by whom the payments are made. In certain circumstances the provision will extend to cases where payment is dependent upon the use, production or profits of the recipient of the payments or of third parties.

16. For example, an agreement with a non-resident who furnishes the information may provide that the payor has the right to pass on the

information to other persons who may make payments to the payor according to the use, benefit, production, sales or profits which they in turn derive. In such a case, the payments to the non-resident will be subject to tax.

17. Where an initial payment of such a fixed sum is coupled with future payments depending upon use, production or profits, the Department will normally regard the initial payments as separate. This will be a question of fact to be determined in each set of circumstances and will depend on a number of factors, including the relationship of the payor and recipient, the nature of the particular business, any history of similar payments and the degree of certainty that there will be subsequent payments after the initial payment.

18. The Department does not regard a once-and-for-all payment in a predetermined amount for such information (such as the right to attend a viewing or an exhibition) as a payment which is dependent in whole or in part upon use, production or profits.

19. For example, in the fashion design business payments may be divided into two general types: payments for the right to "view" the non-resident's styles and designs, and payments for the use of the information so obtained. In general, provided that the former payments are unqualified, do not involve the furnishing of drawings or designs and do not depend upon the use of the information obtained, they will not be subject to tax under this subparagraph. On the other hand, where the information is subsequently used and payments are made for such use, these payments may be subject to tax, depending on the circumstances, under either subparagraph (i), if designs or models are used in Canada, or (ii), if the payments are based upon use, production or profits.

Payments for Services (subparagraph 212(1)(d)(iii))

20. Under this provision, any payment for services of an industrial, commercial or scientific character performed by a non-resident person will be subject to tax where the total amount payable as consideration for such services is dependent in whole or in part upon:

- (a) the use to be made thereof or the benefit to be derived therefrom;
- (b) production or sales of goods or services; or
- (c) profits.

21. Such payments will be taxable regardless of

where services are rendered except in the circumstances contemplated in subparagraph 212(1)(d)(x), where a portion of the amount is deductible in computing the income of the payor under Part I from a business carried on by him in a country other than Canada (see paragraph 33 below). Similarly, taxability does not necessarily rest upon the payments being dependent on use, production or profits of the person by whom the payments are made. In certain circumstances, the provision will extend to cases where payment is dependent upon the use, production or profits of the recipient of the payments or of third parties. Payments for services performed in connection with the sale of property or the negotiation of contracts are excepted.

22. Where fees are charged for services on a per hour, per diem or similar basis, it is a question of fact whether the amount depends upon the use to be made or the benefit to be derived from such services.

23. Examples of payments which may fall within this subparagraph are:

- (a) fees for technical or production services where the amount of such fees depends in any way upon performance or productivity; and
- (b) charges for product development and marketing know-how or research which vary in accordance with production or sales.

24. Payments which fall within the description of management or administration fees or charges within the meaning of paragraph 212(1)(a) are not regarded as payments for services of an industrial, commercial or scientific character referred to in subparagraph 212(1)(d)(iii). Whereas the former relate to the staff, administrative or managerial functions of an operation, the latter are more directly related to its income-producing activities. For example in the case of a hotel operation, the management and administration side would include hiring and other personnel services and the designing of accounting, security, inventory and catering systems, while promotion and publicity, entertainment booking and reservation and credit card services, as such, normally fall within the category of services of an industrial or commercial character. However, if a payment is for services which are principally in the nature of management or administration, the Department will not regard it as partly for services of an industrial, commercial or scientific character even though some elements of the latter may be present. To the extent that the

payment would be a management or administration fee as described in paragraph 212(1)(a), if it falls within the exempting provisions of subsection 212(4) it will not be subject to tax under either paragraph 212(1)(a) or subparagraph 212(1)(d)(iii).

Payments to Non-Residents Carrying on Business in Canada

25. Where any of the payments referred to in paragraph 212(1)(d) are made to a non-resident person who carries on business in Canada and the payments may reasonably be attributed to the business carried on by him in Canada, the non-resident person will not be subject to tax under Part XIII of the Act, but under Part I (subsection 805(1), Income Tax Regulations). However, unless the person making the payments is authorized by the Minister (under subsection 805(2) of the Regulations) to make such payments without any deduction under section 215, he will be held personally liable for the tax if the non-resident recipient is found not to have been carrying on business in Canada.

Division or Allocation of Payments

26. The Department recognizes that there may be circumstances in which a payment may reasonably be regarded as being in part a payment which is subject to tax under paragraph 212(1)(d) and in part a payment which is not subject to such tax. This might occur, for example, if a payment is made for the use or right to use property in Canada and in other countries. In general, the Department will take the position that the full amount of such a payment is subject to tax, but will be prepared to review the matter where the taxpayer or the Canadian resident paying the amount can provide satisfactory evidence that a portion of any such payment should not be subject to the tax.

Payments for Exclusivity or Agreements Not to Use (subparagraph 212(1)(d)(iv))

27. This provision applies to payments made to a non-resident to ensure that certain property or information will not be used by the payee or his licensee,

- (a) in the case of items described in subparagraph 212(1)(d)(i), in Canada, or
- (b) in the case of information concerning industrial, commercial or scientific experience, either in Canada or elsewhere.

Copyright (subparagraph 212(1)(d)(vi))

28. Royalties and similar payments in respect of a copyright on a literary, dramatic, musical or artistic work are not subject to withholding tax under paragraph 212(1)(d) by virtue of subparagraph 212(1)(d)(vi). However, as provided by subsection 212(5), payments for a right in or the use of a motion picture film or a film or video tape for use in connection with television that is to be used or reproduced in Canada is subject to a withholding tax of 25% (unless reduced by treaty).

Bona Fide Cost-sharing Arrangements (subparagraph 212(1)(d)(viii))

29. This subparagraph excludes from the tax otherwise imposed under paragraph 212(1)(d) payments made under a bona fide cost-sharing arrangement under which the person making the payment shares on a reasonable basis with one or more non-resident persons research and development expenses in exchange for an interest in all property or other things of value that may result therefrom.

30. The Department considers that for a bona fide cost-sharing arrangement to exist, the following features must be present:

- (a) in addition to sharing research and development costs, any benefits or income resulting from that research and development must also be shared;
- (b) such costs and revenues must be shown to have been shared on a reasonable basis (the Department does not necessarily regard sales, production or profits as establishing a reasonable basis for sharing costs);
- (c) while only a portion of the cost may be charged to the Canadian resident, he must receive an interest in all property or other things of value resulting from the arrangement;
- (d) the Canadian resident should have title or full access to, or a real and genuine interest (and in the case of non-arm's-length transactions generally an unrestricted interest) in, all property or things of value generated by the research and development, including patents and know-how, except that:
 - (i) where the non-resident does not permit the Canadian resident to have title to a patent, design, etc., the latter should have unrestricted use of it at no additional cost; and
 - (ii) geographical restrictions would be permissible so long as the Canadian

resident were entitled to use the property in question anywhere in Canada where he has a manufacturing or sales operation;

- (e) double charges should not arise through charging a taxpayer for a portion of the research and development costs and also a royalty for the subsequent use of the property.

31. In each case, the Department would wish to test the propriety of the cost-sharing basis by examining the value or potential value of the arrangement to the Canadian resident and by ascertaining whether its share of the total costs was in line with the size and nature of its operations and whether it is likely to benefit from the arrangement in the light of the relationship of its size, operations and contribution to the size, operations and contributions of all the contributors taken together.

32. The words "research and development" are quite broad and are interpreted as including not only scientific research and development but also certain of the activities specifically excluded from the definition of "scientific research" contained in section 2900 of the Regulations.

Payments Deductible from Income of a Foreign Business (subparagraph 212(1)(d)(x) of the Income Tax Act)

33. A payment which is made by a resident of Canada to a non-resident person with whom he is dealing at arm's length and which is deductible in computing the income of the payor under Part I from a business carried on by him in a country other than Canada, is exempt from withholding tax to the extent it was so deductible (subparagraph 212(1)(d)(x)). For example, a Canadian resident who makes a deductible payment for scientific information used in the course of his business in a foreign country will not have made a payment subject to tax under paragraph 212(1)(d), even if the payment is based upon production or sales.

Tax Treaties

34. Where a person makes know-how or similar payments to a resident of a country with which Canada has a comprehensive tax treaty in force, the appropriate convention or agreement should be consulted both as to taxability of the payment and applicable rates.

35. For example, although paragraph 212(1)(d) and subsection 212(5) provide for a withholding tax of 25% on royalties or similar payments, a

number of provisions in the Canada-U.S. Income Tax Convention (1980) may affect the taxation of such payments where the beneficial owner of the royalties is a resident of the United States. Article XII of the Canada-U.S. Income Tax Convention (1980) limits the rate of withholding tax on such payments to 10% provided that the property or right on which the royalties are paid is not effectively connected with a "permanent establishment" (Article V of the Convention) through which the non-resident beneficial owner carries on a business in Canada or a fixed base in Canada through which the non-resident beneficial owner performs independent personal services. Where the right or property is effectively connected with a permanent establishment or a fixed base in Canada, the royalty income, including that in respect of the production or reproduction of any literary, dramatic, musical or artistic work, is taxed under the provisions of Article VII (business profits) or Article XIV (independent personal services).

The Canada-U.K. Income Tax Convention (1978) provides rules similar to those of the Canada-U.S. Income Tax Convention (1980).

EXCERPT FROM CANADA-U.S. TAX CONVENTION

Article XII

Royalties

1. Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.
2. However, such royalties may also be taxed in the Contracting State in which they arise, and according to the laws of that State; but if a resident of the other Contracting State is the beneficial owner of such royalties, the tax so charged shall not exceed 10 per cent of the gross amount of the royalties.
3. Notwithstanding the provisions of paragraph 2, copyright royalties and other like payments in respect of the production or reproduction of any literary, dramatic, musical or artistic work (but not including royalties in respect of motion picture films and works on film or videotape for use in connection with television) arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.

4. The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work (including motion picture films and works on film or videotape for use in connection with television), any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, tangible personal property or for information concerning industrial, commercial or scientific experience, and, notwithstanding the provisions of Article XIII (Gains), includes gains from the alienation of any intangible property or rights described in this paragraph to the extent that such gains are contingent on the productivity, use or subsequent disposition of such property or rights.

5. The provisions of paragraphs 2 and 3 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article VII (Business Profits) or Article XIV (Independent Personal Services), as the case may be, shall apply.

6. For the purposes of this Article, royalties shall be deemed to arise in a Contracting State when the payor is that State itself, or a political subdivision, local authority or resident of that State. However:
 - (a) Except as provided in subparagraph (b), where the person paying the royalties, whether he is a resident of a Contracting State or not, has in a State other than that of which he is a resident a permanent establishment or a fixed base in connection with which the obligation to pay the royalties was incurred, and such royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated and not in the State of which the payor is a resident; and
 - (b) Where the royalties are for the use of intangible property or tangible personal property in a Contracting State, then such royalties shall be deemed to arise in that State and not in the State of which the payor is a resident.

7. Where, by reason of a special relationship between the payor and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payor and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

8. Where a resident of a Contracting State pays royalties to a person other than a resident of the other Contracting State, that other State may not impose any tax on such royalties except insofar as they arise in that other State or insofar as the right or property in respect of which the royalties are paid is effectively connected with a permanent establishment or a fixed base situated in that other State.

EXCERPT FROM CANADA- UNITED KINGDOM TAX CONVENTION

Article XII

Royalties

1. Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, such royalties may be taxed in the Contracting State in which they arise, and according to the law of that State; but if the recipient is the beneficial owner of the royalties the tax so charged shall not exceed 10 per cent of the gross amount of the royalties.

3. Notwithstanding the provisions of paragraph 2, copyright royalties and other like payments in respect of the production or reproduction of any literary, dramatic, musical or artistic work (but not including royalties in respect of motion picture films and works on film or videotape for use in connection with television) arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.

4. The term "royalties" as used in this Article means payments of any kind received as a

consideration for the use of, or the right to use, any copyright, patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience, and includes payments of any kind in respect of motion picture films and works on film or videotape for use in connection with television.

5. The provisions of paragraphs 1, 2 and 3 shall not apply if the recipient of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein, or performs in that other State professional services from a fixed base situated therein, and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment or fixed base. In such a case, the provisions of Article 7 or Article 14, as the case may be, shall apply.

6. Royalties shall be deemed to arise in a Contracting State when the payor is that State itself, a political subdivision, a local authority or a resident of that State. Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment in connection with which the obligation to pay the royalties was incurred, and those royalties are born as such by that permanent establishment, then such royalties shall be deemed to arise in the Contracting State in which the permanent establishment is situated.

7. Where, owing to a special relationship between the payor and the person deriving the royalties or between both of them and some other person, the amount of the royalties paid exceeds for whatever reason the amount which would have been paid in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In that case, the excess part of the payments shall remain taxable according to the law of each Contracting State, due regard being had to the other provisions of this Convention.

APPENDIX III-D

Payments to Non-Residents

105.(1) Every person paying to a non-resident person a fee, commission or other amount of services rendered in Canada, of any nature whatever, shall deduct or withhold 15 per cent of such payment.

(2) Subsection (1) does not apply to a payment described in the definition "remuneration" in subsection 100(1).

Regulation 100(1)

"remuneration includes any payment that is:

- (a) in respect of
 - (1) salary or wages

APPENDIX III-E

JOINT VENTURES IMPLEMENTATION CHECKLIST

DEFINE SCOPE AND PURPOSE

- Products
- Market Area
- Limitations

ASSESS AND EVALUATE CONTRIBUTIONS OF PARTIES

- Plant
- Equipment
- Technology
- Technical Assistance
- Supply of Raw Materials/Components
- Personnel
 - Management
 - General
 - Financial
 - Marketing
 - Personnel
 - Plant
 - Technical

- Cash
- Bank Guarantees
- National Identity/Relationship with Government
- Other

CAPITALIZATION

- Cash
- Loans from Participants
 - Interest Bearing
 - Non-Interest Bearing

Borrowing from Third Parties

- Term
- Interest Rates
- Other Terms and Conditions

Security

- Assets
 - Plant and Equipment
 - Inventory
 - Receivables
 - Fixed Charge
 - Floating Charge

Participant Guarantees

Contribution of Tangible Assets

- Capitalization
- Sale
- Lease

Contribution of Intellectual Property Rights

- Capitalization
- Sale
- License

Contribution of Technical Assistance/Management Services

- Capitalization
- Fee Structure
- Reimbursement of Costs

Consider Independent Valuations where Available.

EVALUATE ALTERNATIVE FORMS FOR JOINT VENTURE

Equity Joint Venture

- Incorporated
- Contractual

Non-Equity Arrangement

- Some combination of:
 - Raw Materials or Component Supply
 - Contract
 - Subcontracting
 - Distribution Agreement
 - Licensing Agreement
 - Technical Assistance

Consider Division into Preparatory and Long-Term Phases

ALLOCATE PROPORTIONATE EQUITY SHARES

CONTROL

- Overall Strategy
 - Shared
 - One Party
 - Independent
- Ongoing Management
 - General
 - Financial
 - Marketing

Personnel
Plant
Technical

Participant Nominees
Hired at Large

USE OF TECHNOLOGY

Refer to Licensing Checklist, Appendix III-A

TECHNICAL ASSISTANCE

Refer to Text, pages 54.

PREPARE NON-BINDING HEADS OF AGREEMENT/LETTER OF AS BASIS FOR FORMAL DOCUMENTS

PREPARE AGREEMENT FOR INCORPORATED JOINT VENTURE

Jurisdiction of Incorporation

Name of Joint Venture Corporation (English and French)

Parties

Name
Address
Principal Office
Incorporated in
Short Title

Recitals (Purpose)

Role of Each Party
Basis of Relationship
Intention to form an unincorporated joint

venture

Other

Definitions

Articles of Incorporation and By-Law

Provisions (see below)

Unanimous Shareholder Agreement

Restrictions on Powers of Directors

Capitalization and Transfer of Property

Future Funding

Further Capital Contributions by Parties

Consequences of Failure to Meet Obligations

Forced Sale

Dilution of Interest

Forfeiture of Interest

Termination of Venture

Long-Term Financing Plan

Decisions Requiring Unanimity

Rights of Access to Plant/Records

Marketing

Responsibility

Pricing Policy

Participants

Unrelated customers

Warranty and service policy

Terms and Conditions of Sale

Material/Component Supply Obligations

Purchase Obligations

Duration

For ____ years

Until specified date

Until specified event

Unlimited

Provisions for Termination

Fundamental Breach

Failure to Meet Objectives

Force Majeure

Definition

Notice of Event

Suspension of Performance

Termination

Transfer of Interest

Direct Transfer

Change in Control of Participant

Free Transfer

No transfer without consent of all parties

Consent not be unreasonably withheld

Consent may arbitrarily be withheld

Right of first refusal to match third-party offer

Notification of third-party offer

Time for submission of matching offer

Alternative basis for determining buyout price (e.g., net book value)

Time allowed to accept third-party offer if right of refusal not exercised.

Transferee to assume transferor's obligation under joint venture agreement.

Right to offer other party, then sell to third party if offer not accepted.

Procedures and time restraints

Buy-Sell Agreement

Rights on Termination

Confidentiality/Return of Confidential Data

Use or Non-Use of Joint Venture Name
Disposition of Property
 Tangible
 Intangible
Final Accounting
Preservation of Records

Governing Law

Arbitration
 Rules
 Situs

Force Majeure

Government Approvals

No Agency

Further Assurances

Notices

PREPARE OR AMEND ARTICLES OF INCORPORATION

Name

English and French (or Bilingual)
Objects

Under Ontario and Federal Statutes
"corporation has the capacity and the
rights, powers and privileges of a natural
person".

Classes of Authorized Shares

Rights Attaching to Each Class
Under Ontario and Federal Statutes, may
provide for any unlimited number of
Common Shares to be issued for an
unlimited amount of consideration.

"Private Corporation" Clauses

No Transfer of Shares Without Director
or Shareholder Approval
Number of shareholders limited to not
more than 50.

Any invitation to the public to subscribe
for securities of the corporation is
prohibited.

Incorporators
Other

PREPARE BY-LAWS FOR JOINT VENTURE CORPORATION

Interpretation

Directors

Powers
Number
Quorum
Qualifications
Election and Term
Removal/Resignation
Vacancies
Canadian Majority
Meetings
 Place
 Calling
 Notice
 Adjournment
 Meetings by Telephone
 Chairman
 Casting Vote
 Votes to Govern
 Quorum
 Conflict of Interest
 Remuneration and Expenses
 Resolutions in Lieu of Meeting
 Delegation
 Management Committee
 Managing Director

Officers

Appointment
Chairman of the Board
Managing Director
President, Vice President, Secretary, Treasurer
Other Officers
Variation of Powers and Duties
Term of Office
 Limitations of Authority

Protection of Directors and Officers

Limitation for Liability
Indemnity
Insurance

Shares

Allotment and Commissions
Registration of Transfer/Transfer Agents
Lien on Shares/Enforcement of Lien
Share Certificate
Joint Shareholders (one certificate)

Meetings of Shareholders

Annual Meeting

Special Meetings
Place of Meetings
Notice of Meetings
List of Shareholders Entitled to Attend
Record Dates
Meetings Without Notice
Chairman, Secretary and Scrutineers
Persons Entitled to be Present
QUORUM
Right to Vote
Voting of Hypothecated Shares
Proxies
Votes to Govern/Show of Hands/Ballots
Adjournments
Resolutions in Lieu of Meeting

Dividends and Rights
Dividends
Payment Provisions

Notices
Method/Proof of Service
Undelivered Notices
Omissions and Errors
Waiver of Notice

Execution of Documents
Signing Officers
Corporate Seal

FISCAL YEAR

ALTERNATIVELY, PREPARE AGREEMENT FOR UNINCORPORATED (CONTRACTUAL) JOINT VENTURE

Parties
Name
Address
Principal Office
Incorporated in
Short Title

Recitals
Role of Each Party
Basis of Relationship
Intention to form an unincorporated joint
venture
Other

Purposes and Name of Joint Venture

Allocation of Proportionate Equity Interests

Capitalization
Divided or undivided interests in property

used by venture.
Refer to CAPITALIZATION

Control

General

Shared

Joint Venture Committee (or
Alternatives)
Meetings
Refer to DIRECTORS
Voting
Budget Approval
Major Expenditures
Change of Scope
Approval of Procedures, Manual
Receive and Approve Periodical
Reports of Manager
Approve Settlement of Claims
Other

Management

Shared

Division of Responsibilities
Nomination of Management Personnel

Refer to VI above.

Delegation to one of the Parties

Terms spelled out in joint venture
agreement

Separate management agreement

Produce procedures manual
Manager to act in own name on
behalf of venture

Feasibility Study
Design and Specifications
Prepare Annual Budget for
approval of Joint Venture
Committee

Periodic reports to Joint Venture
Committee

Employ personnel

Employees of manager or of both parties
(the Venture)

Maintain books of account and other records

Prepare and file tax returns

Keep joint venture in good standing

Limitations on Authority

Financing

Parties to share costs in equal or other
designated proportions

Disposition of pre-venture costs

Each party responsible for own costs
Reimbursed from venture

Future Funding

Refer to CAPITALIZATION above.

Accounting

- Determine fiscal year
- Special accounting procedures (reference to schedules)
- Designate accounting books and records to be maintained
- Access by each party
- Nature and frequency of statements

No Agency or Partnership

- No party the partner, agent or representative of others
- Cross indemnities respecting liabilities arising outside scope of venture
- Notification of third party actions against parties

Duration

- For _____ years
- Until specified date
- Until specified event such as incorporation of venture or execution of further agreement for subsequent phase
- Termination after default period to rectify defaults
- No opportunity to rectify
- Unlimited

Termination

- Upon bankruptcy or insolvency of either party.
- Upon default in performance if not remedied within prescribed period.
- Upon change in control of a party.
- Event of force majeure extending beyond period of suspension.

Rights on Termination

- Confidentiality/Return of Confidential Data
- Name of Venture
- Disposition of joint venture assets
 - Tangible
 - Intangible
- Final Accounting
- Preservation of Records

Force Majeure

- Definition of force majeure
- Notification of event
- Suspension of obligations
- Termination

Notices

Amendment of Agreement

Time of the Essence

Entire Agreement

APPENDIX III-F

*Revenue Canada Interpretation Bulletin No. IT-468
Management or Administration Fees paid to Non-Resident*

1. Every non-resident is required by paragraph 212(1)(a) to pay an income tax of 25% on every amount that is a management or administration fee or charge that a resident of Canada pays or credits to him. Every amount of such fee or charge deemed by Part I to have been paid or credited to a non-resident is also subject to tax of 25%.

However, the rate of tax may be subject to reduction pursuant to ITAR 10(6) and a Tax Convention between Canada and the country in which the payee resides. For applicable non-resident tax rates on amounts paid or credited to residents in treaty countries refer to Information Circular 76-12R. The meaning of the word "credited" is discussed in Information Circular 77-16.

2. A management or administration fee or charge is not defined in the Act. For the purposes of paragraph 212(1)(a) the Department considers that the term "management or administration" generally includes the functions of planning, direction, control, co-ordination, systems or other functions at a managerial level. These functions may involve services for various departments of a business such as accounting, financial, legal, electronic data processing, employee relations, management consultation, labor negotiations, taxation etc. relating to the management or administration. It is not possible to provide an all-inclusive definition of management fees in an interpretation bulletin, and it is suggested that the above comments be read together with the comments below in order to determine whether an amount paid or credited to a non-resident in a particular set of circumstances constitutes a management fee that is subject to a non-resident tax under paragraph 212(1)(a).

3. Whether a particular amount paid or credited to a non-resident for services performed constitutes a management or administration fee or charge should be determined on the basis of the nature of the services performed. If no identifiable services

have been performed, amounts billed as management or administration fees or charges will be considered subject to paragraph 212(1)(a). Amounts paid for services actually performed, which may casually be described as management fees but in substance are for something else which can be identified, will not be subject to non-resident tax under paragraph 212(1)(a) or to the exclusion therefrom under subsection 212(4). Such amounts may, however, be subject to non-resident tax under provisions of Part XIII other than paragraph 212(1)(a), or the amounts may be taxable under Part I. For example, a payment to a non-resident for the use of a right or invention, or for information concerning commercial or scientific knowledge may be subject to non-resident tax under paragraph 212(1)(d). Where the ordinary course of the business of a non-resident includes the service of providing management advice in Canada, a fee for such services may be subject to tax as income earned in Canada under Part I. A salary paid or credited to a non-resident person is not considered a management or administration fee or charge but it may, nevertheless, be subject to Part I tax.

4. Subsection 212(4) excludes from management or administration fee or charge for purposes of paragraph 212(1)(a), the following amounts to the extent that they are reasonable in the circumstances:

- (a) an amount paid or credited to a non-resident for a service performed provided that the service was performed in the ordinary course of a business carried on by the non-resident and the non-resident and the payor were dealing with each other at arm's length at the time of the performance of such service, or
- (b) an amount paid or credited to a non-resident provided that the amount was a reimbursement of a specific expense incurred by him for the performance of a service and the service performed by the non-resident was for the benefit of the payor.

5. The Department considers that the term "a specific expense" in 4(b) above applies to a particular expense item or a portion thereof, a sum of several expense items or a portion of a composite of various distinct expenses such as overhead expense including rent, power, heat, salaries, fringe benefits and other business expenses. A specific expense does not include depreciation, capital costs, reserves or unvouchered amounts. A specific expense is net, after all

applicable credits or refunds have been deducted, and is without any mark-up or profit element to the non-resident. While only amounts deductible under the Income Tax Act will be allowed to the Canadian payor in computing his income, this factor is immaterial in determining whether an amount represents a reimbursement to the non-resident of a specific expense for purposes of 4(b) above.

6. For purposes of 4(b) above, a service performed by a non-resident would not be considered beneficial to the payor if it was a duplication for services already provided by the payor's own personnel.

7. It is a question of fact whether an amount paid or credited to a non-resident is reasonable in the circumstances for purposes of 4 above. In making such a determination consideration should primarily be given to the quantum or amount of the exclusion sought in relation to the service performed and the benefit derived by the payor. Where an amount paid or credited to a non-resident is based on an allocation or distribution of certain charges or costs among various departments, branches or subsidiary corporations (including the Canadian payor), it is important not only that the expenses themselves are reasonable but that the method or basis of allocation or distribution is appropriate to the Canadian payor and reasonable in the circumstances.

8. Where the fee or charge exceeds the amount excluded under 4(a) or (b) above, only the excess will be subject to Part XIII tax. If the fee or charge is not reasonable in the circumstances, the unreasonable portion, in addition to being subject to Part XIII tax will be disallowed under section 67 or subsection 69(2) as an expense of the Canadian payor. In considering the reasonableness of the fee or charge for purposes of section 67 and subsection 69(2), the Department is prepared to recognize a reasonable mark-up or profit on specific expenses incurred by the non-resident in performing the services for the benefit of the Canadian payor.

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Ministry of Industry, Trade and Technology

Province of Ontario
Queen's Park
Toronto, Canada
M7A 2E1

Monte Kwinter
Minister

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